

# THE GLOOM, BOOM & DOOM REPORT

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## Dow Jones below 1,000?

“There is a great difference between knowing and understanding: you can know a lot about something and not really understand it.”

*Charles F. Kettering*

“You never really understand a person until you consider things from his point of view.”

*Harper Lee (Atticus Finch, in To Kill a Mockingbird)*

“Anger and intolerance are the enemies of correct understanding.”

*Mohandas K. Gandhi*

“On the whole men are more good than bad; that, however, isn't the real point. But they are more or less ignorant, and it is this that we call vice or virtue; the most incorrigible vice being that of an ignorance which fancies it knows everything and therefore claims for itself the right to kill.”

*Albert Camus*

### INTRODUCTION

When the highly successful Football World Cup held in South Africa came to an end, the great winner wasn't Germany's Miroslav Klose, Argentina's Lionel Messi, Spain's David Villa, Uruguay's Diego Forlan, or Arjen Robben of the Netherlands, but an octopus by the name of Paul who lives in an aquarium at Sea Life in Oberhausen, Germany. Paul correctly predicted all the winners of

the final rounds. I think that investors also desperately need Paul the octopus to tell them where stocks, bonds, currencies, and commodities will be trading at in a year's time, because — at least so far — I have not found a reliable forecaster of future events and market movements (but more on this later).

An article by Robert Reich (secretary of labor under President Bill Clinton) entitled “We're in a Recession because the Rich are

Raking in an Absurd Portion of Wealth” caught my attention recently (see *New York Times*, July 7, 2010). Reich notes:

Our economy can't thrive when the richest 1 percent get an ever larger share of the nation's income and wealth, and everyone else's share shrinks. Wall Street's banditry was the proximate cause of the Great Recession, not its underlying cause. Even if the

Street is better controlled in the future (and I have my doubts), the structural reason for the Great Recession still haunts America. That reason is America's surging inequality. Consider: in 1928 the richest 1 percent of Americans received 23.9 percent of the nation's total income. After that, the share going to the richest 1 percent steadily declined. New Deal reforms, followed by World War II, the GI Bill and the Great Society, expanded the circle of prosperity. By the late 1970s the top 1 percent raked in only 8 to 9 percent of America's total annual income. But after that, inequality began to widen again, and income reconcentrated at the top. By 2007 the richest 1 percent were back to where they were in 1928 — with 23.5 percent of the total.

Each of America's two biggest economic crashes occurred in the year immediately following these twin peaks — in 1929 and 2008. This is no mere coincidence.

**When most of the gains from economic growth go to a small sliver of Americans at the top, the rest don't have enough purchasing power to buy what the economy is capable of producing.** America's median wage, adjusted for inflation, has barely budged for decades. Between 2000 and 2007 it actually dropped. Under these circumstances the only way the middle class can boost its purchasing power is to borrow, as it did with gusto. As housing prices rose, Americans turned their homes into ATMs. But such borrowing has its limits. When the debt bubble finally burst, vast numbers of people couldn't pay their bills, and banks couldn't collect [emphasis added].

Reich then notes that “the structural problem began in the late 1970s, by which time a wave of new technologies (air cargo, container ships and terminals, satellite communications, and, later, the Internet) had radically reduced the costs of outsourcing jobs abroad”,

while “as the pay of most workers flattened or dropped, the pay of well-connected graduates of prestigious colleges and MBA programs — the so-called “talent” who reached the pinnacles of power in executive suites and on Wall Street — soared.”

So far so good! Reich makes some prescient observations. But then he asks why so little was done to counteract these forces.

**Government could have given employees more bargaining power to get higher wages, especially in industries sheltered from global competition and requiring personal service: big-box retail stores, restaurants and hotel chains, and child- and eldercare, for instance. Safety nets could have been enlarged to compensate for increasing anxieties about job loss: unemployment insurance covering part-time work, wage insurance if pay drops, transition assistance to move to new jobs in new locations, insurance for communities that lose a major employer so they can lure other employers. With the gains from economic growth the nation could have provided Medicare for all, better schools, early childhood education, more affordable public universities, more extensive public transportation. And if more money was needed, taxes could have been raised on the rich** [emphasis added].

But wait, it gets even better. According to Reich, instead of raising taxes on the rich, the government, starting in the late 1970s, did “just the opposite”.

It deregulated and privatized. It increased the cost of public higher education and cut public transportation. It shredded safety nets. It halved the top income tax rate from the range of 70–90 percent that prevailed during the 1950s and '60s to 28–40 percent; it allowed many of the nation's rich to treat their income as

capital gains subject to no more than 15 percent tax and escape inheritance taxes altogether. At the same time, America boosted sales and payroll taxes, both of which have taken a bigger chunk out of the pay of the middle class and the poor than of the well-off.

Companies were allowed to slash jobs and wages, cut benefits and shift risks to employees (from you-can-count-on-it pensions to do-it-yourself 401(k)s, from good health coverage to soaring premiums and deductibles). They busted unions and threatened employees who tried to organize. The biggest companies went global with no more loyalty or connection to the United States than a GPS device. Washington deregulated Wall Street while insuring it against major losses, turning finance — which until recently had been the servant of American industry — into its master, demanding short-term profits over long-term growth and raking in an ever larger portion of the nation's profits. And nothing was done to impede CEO salaries from skyrocketing to more than 300 times that of the typical worker (from thirty times during the Great Prosperity of the 1950s and '60s), while the pay of financial executives and traders rose into the stratosphere.... It's too facile to blame Ronald Reagan and his Republican ilk. Democrats have been almost as reluctant to attack inequality or even to recognize it as the central economic and social problem of our age. (As Bill Clinton's labor secretary, I should know.) **The reason is simple. As money has risen to the top, so has political power. Politicians are more dependent than ever on big money for their campaigns.** Modern Washington is far removed from the Gilded Age, when, it's been said, the lackeys of robber barons literally deposited sacks of cash on the desks of friendly legislators. Today's cash comes in the form of ever increasing campaign donations

from corporate executives and Wall Street, their ever bigger platoons of lobbyists and their hordes of PR flacks...

**If nothing more is done, America's three-decade-long lurch toward widening inequality is an open invitation to a future demagogue who misconnects the dots, blaming immigrants, the poor, government, foreign nations, "socialists" or "intellectual elites" for the growing frustrations of the middle class. The major fault line in American politics will no longer be between Democrats and Republicans, liberals and conservatives. It will be between the "establishment" and an increasingly mad-as-hell populace determined to "take back America" from them.**

When they understand where this is heading, powerful interests that have so far resisted reform may come to see that the alternative is far worse [emphasis added].

Although I think that Reich's piece contains some serious economic flaws, it would be wrong to completely dismiss him as a socialist interventionist and a hard-core anti-capitalist. However, my problem with Reich is this. Although I tend to agree that the current economic problems are partly due to "gains from economic growth going to a small sliver of Americans at the top", these outsized gains don't necessarily mean "the rest don't have enough purchasing power to buy what the economy is capable of producing". If we consider that consumption as a percentage of GDP has increased since the early 1980s from 62% to over 70% at present, there is no evidence that there was no purchasing power (see Figure 1).

The problem, which I concede that Reich correctly identifies (at least partially), was that, given stagnating real incomes, "the only way the middle class" could "boost its purchasing power" was "to borrow, as it did with gusto". Still, no one forced the middle classes "to borrow money" and to boost their consumption as a

percentage of the economy (although easy monetary policies encouraged the accumulation of household debts). The middle classes could also have saved more and put money aside for their retirement, improved their professional skills through further education, and worked harder and for longer hours instead of watching baseball, basketball, and football games all day on TV. To some readers this may sound politically incorrect, but the fact remains that, every once in a while in life, conditions get tough; when that happens, the answer is not simply to borrow money in order to boost consumption (borrowing money for the purpose of capital spending, such as for further education during holidays, would be another matter), but to face reality and make the necessary adjustments even if they mean a temporary reduction in one's standard of living. I should also mention that it is not the case, as Reich seems to imply, that the rich don't pay enough taxes. Some 47% of American people either pay no federal income taxes or are recipients of transfer payments that exceed their federal tax payments.

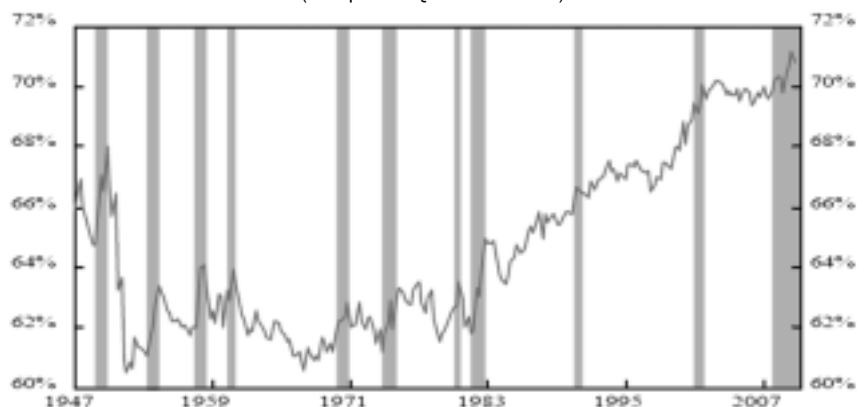
In my opinion, the central problem in the US was not a lack of purchasing power, but the fact that the purchasing power of "the rest" was spent not on domestic goods but on imports, as is evident from the US trade deficit, which is again on the increase (see Figure 2). And why was

the purchasing power of "the rest" not spent on domestic goods? There are many reasons for this, but Reich's suggestions (highlighted above in bold, and reproduced below) may provide some explanation for corporate America's preference for investing in foreign countries and for why domestically produced goods are frequently hopelessly uncompetitive compared to foreign-made goods (and hence the large trade deficit): "Government could have given employees more bargaining power to get higher wages.... Safety nets could have been enlarged [such as] unemployment insurance covering part-time work ... Medicare for all.... [And] taxes could have been raised on the rich."

Similar to Paul Krugman, Reich thinks that the government didn't intervene in the free market sufficiently, and that more interventions would have been — and still are — appropriate, and would have "miraculously" solved all the problems. I explained at great length the economic policy errors made over the last two decades in the April 7, 2010 GBD report entitled "The More Conscious an Economist is of the Weak Spots of His Theory, the More Certain He is to Speak With an Air of Final Authority", so I shall refrain from repeating myself here. But I should re-emphasize that expansionary monetary policies — especially beginning after the LTCM

Figure 1 **Too Little Consumption?**

**Personal Consumption Expenditures as a % of GDP**  
(last point 4Q 2009: 70.8%)



Source: Gary Shilling, [insight@agaryshilling.com](mailto:insight@agaryshilling.com)

Figure 2 US Trade Balance, 1960–2010



Source: Ron Griess, [www.thechartstore.com](http://www.thechartstore.com)

crisis and in force up to the present day — fostered the colossal debt expansion at all levels of society (not just among the middle class) and led first to the Nasdaq, and later the housing, bubble. And as I pointed out in the April report, “every asset bubble makes people feel temporarily rich, because on the back of rising asset prices the owners of assets can increase their borrowings or trade out of their inflated assets and consume more than if no asset bubble had taken place. In other words, in an asset bubble, people can consume today out of borrowings and capital gains what in a non-inflationary environment they would have consumed through accumulated savings. Simply put, asset bubbles ‘frontload’ consumption at the expense of consumption when the bubble bursts.” A recent *Time* magazine article asked: “How did so many people forget all at once that a bubble always bursts?” Robert

Prechter (see also below) responded: “The answer, of course, is that the bubble hijacked people’s reasoning faculties.” Especially the “reasoning faculties” of the US Fed, I might add!

Also, I agree with Reich that “modern Washington is far removed from the Gilded Age, when, it’s been said, the lackeys of robber barons literally deposited sacks of cash on the desks of friendly legislators”, but that “today’s cash comes in the form of ever increasing campaign donations from corporate executives and Wall Street, their ever bigger platoons of lobbyists and their hordes of PR flacks”. But this is nothing new. Theodore White (*Time* magazine’s first foreign correspondent) observed back in the 1970s that “the flood of money that gushes into politics today is a pollution of democracy”. But I think this unfortunate state of affairs worsened because the US Federal Reserve under Mr. Greenspan and

Mr. Bernanke enriched the financial sector with its accommodative monetary policies. Between 1960 and 1984, banks, brokerage firms, finance companies, and other financial institutions accounted for 12–22.5% of total corporate profits. In 2002, the financial-sector contribution reached 44.75%!

I should further mention that tax cuts (and low taxes) don’t necessarily increase wealth inequality, as Reich seems to suggest (see above). There is no evidence whatsoever that in low-tax regimes such as we find in Hong Kong, Singapore, and Switzerland (in relative terms), and in flat-tax countries (with a flat income tax rate of usually 15% and no capital gains taxes), wealth inequity is larger than in high-tax economies. Exceptions do exist. In Scandinavian countries (including Denmark), very high taxes, but also very efficient governments (very high standards of public education and healthcare),

have created a high degree of social justice. I am mentioning the Scandinavian countries because, whereas their rather socialistic economic model works there, it may not work as well in other economies. As Carl Jung remarked, “A shoe that fits one person pinches another; there is no recipe for living that suits all cases.” This highlights the problem with economic models and government interventions in the free market. In some cases, and at particular times, they may work; whereas in other cases and at other times they may fail. Similar to the medical field, one treatment may work and have positive results on one patient and fail when used on another.

An informed reader of mine recently made the following point:

There are essentially three major reasons for keeping official economic statistics: 1: to give the government ammunition to intervene in the economy. 2: to make the economy look better than it is, which reflects well on the government’s policy decisions. 3: to hide the price effects of inflation, so as to keep inflation-indexed spending down and be able to pretend that the “inflation tax” is lower than it really is. The liberty minded financial secretary of Hong-Kong from 1961 to 1971, Sir John James Cowperthwaite, who is widely credited for introducing the free market oriented policies to Hong Kong that have served it so well over the decades, collected and published almost no economic statistics. He refused to release GDP statistics, and famously sent a UK delegation of bureaucrats that had come to inquire about the unemployment rate packing without the desired information (he simply didn’t have it). Cowperthwaite opined that keeping such statistics would only encourage central planners to, well, centrally plan. He kept personal taxes at a maximum of 15 percent, there was no government borrowing at all,

there were no tariffs, no subsidies, and so little red tape that company registration could be done with a single page form. The result: in 1960, the per capita income in Hong Kong was estimated to be 28% of the UK’s. By 1997, the year of the handover, it had risen to 137% — in an overcrowded city state with practically zero natural resources — oh, and very little by way of economic statistics. A non-interventionist government doesn’t need them.

(Benjamin Disraeli exclaimed that “there are three kinds of lies: lies, damned lies and statistics”.)

But what I really wanted to explain is that, even if in Hong Kong wealth inequity increased somewhat between 1960 and today (which I’m not certain about, to begin with), everybody in Hong Kong is much better off relative to the United Kingdom’s population compared to the 1960s. I am not suggesting that everything is perfect in Hong Kong, but that the application of Adam Smith’s wisdom, who opined that “little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, **easy taxes** and a tolerable administration of justice” (emphasis added), was clearly favourable for an increase in its population’s income and wealth.

But as I said above, it would be wrong to completely dismiss Reich’s views as being those of a socialist and dangerous interventionist who believes that, had his proposed measures been implemented (see above), the US economy would be in better shape. Reich is a clever observer of social trends, and his observation that US current economic and social trends (not necessarily wealth inequity) are “an open invitation to a future demagogue who misconnects the dots, blaming immigrants, the poor, government, foreign nations, ‘socialists’ or ‘intellectual elites’ for the growing frustrations of the middle class. The major fault line in American politics will no longer be

between Democrats and Republicans, liberals and conservatives. It will be between the ‘establishment’ and an increasingly mad-as-hell populace determined to ‘take back America’ from them.”

I think it is already obvious today that the “fault line” in American politics has begun to shift and that an enormous disconnect exists between an unhappy population and the political “establishment”, which is perceived as ineffective and not acting in the interest of the public and of the United States as a nation but in its own interest and the interest of its cronies alone. As Reich further observes, social stability “rests on the public’s trust that the system operates in the interest of us all. Any loss of such trust threatens the well-being of everyone” (The SEC settlement with Goldman Sachs is not a settlement, but a gift to Goldman Sachs, and was announced two days after Warren Buffett visited the White House — of course, there is no connection whatsoever.)

Grant Noble (gnoble@sbcglobal.net) summarises the current state of the US administration in one of his recent missives as follows: “Every time you thought this government couldn’t get any more criminal, they outdo themselves. And Obama continues to rub it in by golfing and partying and giving blatantly partisan and hackneyed speeches. We are turning into lawless Mexico, complete with oligarchs openly running the government, general lawlessness, no choice elections that are in any case loaded with fraud from computer vote counting to all sorts of felons, illegals and phantoms ‘voting’.” He adds: “The sad thing, my European friends, is that you have less hope than we do as you drift to demographic oblivion and Muslim domination.” (Bill King — kingsupport@arborresearch.com — reports in one of his recent, always informative daily comments that, according to the Washington government watchdog Judicial Watch, “in a comical move even for a czar-happy president who has rewarded dozens of cronies with distinguished titles, the White House

has named the Obamas' personal Chicago cook as 'Senior Policy Adviser for Healthy Food Initiatives'.")

Reading between the lines, one gets the impression that Reich is actually very concerned about the future. I have discussed his views extensively, not because I have any sympathy for his proposed economic policies, but because "bearish sentiment" has again gained the upper hand recently, and because Robert Prechter's prediction of a Dow Jones below 1,000 has gained so much attention.

### DOW JONES BELOW 1,000?

I am aware that most of my readers will shake their heads at the prospect of a decline of over 90% in stock prices over the next few years. But this is what Robert Prechter has forecast based on his interpretation of Elliott Waves, Fibonacci numbers, and socioeconomic trends. As my regular readers will know, I don't believe that the March 2009 low of 666 for the S&P 500 will be broken, but I am always open to listening to arguments that challenge my views. According to Prechter, "thanks to the great rise in positive social mood, the stock market remains historically overvalued in terms of dividends and earnings". However, Prechter thinks that the social mood began to change after 2000 and that "the trend toward negative social mood will lead to an economic contraction. Small bear markets lead to recessions; big bear markets lead to depressions. The current bear market will be the biggest in nearly 300 years, so the depression will be correspondingly deep. During the slowdown in economic activity, corporate profits will become losses, earnings will go negative (again), dividends will fall, and the worth of corporations will fall. A depression deeper than that of 1933, which the waves [Elliott Waves — ed. note] portend, could reduce the general value of corporations by 80%. Stock prices will reflect these changes in corporate value" (see Figure 3).

Prechter also discusses "technical reasons" for a major bear market:

The bear market is of Supercycle degree, the biggest since 1720–1784. It should therefore include a decline deeper than the 89% decline of 1929–1932. A decline of 91.5% or more would carry it [the Dow Jones — ed. note] below 1000.... The Supercycle V has ended [wave 5 of wave 5 — ed. note].... The Supercycle bear should carry to its expected target within the range of the previous Supercycle fourth wave, between 41 and 381 on the Dow.... The extreme height that the bull market attained is irrelevant to this target. Declines following manias always carry *below the starting point of the mania*. In May 1977, EWT [The Elliott Wave

Theorist — ed. note] published a study titled "Bulls, Bears, and Manias"... The crashes following the Tulip Mania of the 1630s, the South Sea Bubble of the early 1700s and the Roaring Twenties bull market all brought prices to below the level of the bull market's starting point. In this case, the mania-style bull market — Cycle wave V — started in 1974 at Dow 572. The 1982 low, a possible orthodox end of Cycle wave IV, is at 777. On this basis, the coming crash should take the Dow below 777 and probably below 572 [see Figure 4].

Prechter is looking for a major debt deflation.

Figure 3 The Dow Supercycle Bear Market



Source: Robert Prechter, www.elliottwave.com

Figure 4 **Prechter's Target for the Dow: Possibly Below the 1974 Low**



Source: Ron Griess, [www.thechartstore.com](http://www.thechartstore.com)

The trend toward negative social mood that has been in progress since 2000 and which is about to accelerate will continue to curtail lending and lead to a tidal wave of defaults and a terrific deflation. The amount of outstanding credit today is so large that system-wide defaults could lead to as much as an 80%–90% decline in the volume of dollar-denominated credits worldwide.... In such an environment, **surviving dollars and dollar credits**, representing the denominator of the DJIA, will rise in value, and the Dow — along with everything else not used as money — will fall in dollar price [emphasis added].

Before completely dismissing Prechter as a lunatic I should mention that he has made some very good forecasts. In his 1978 book *Elliott Wave Principle*, he forecasted that the Dow would rise to 2,300.

(He later revised his price target to 2,700.) At the time, no one believed that such a strong upward move was possible, since the 1970s had been a horrible time for equities. I should also mention that he is a friend of mine, and that I always read his newsletters with great interest because they contain a lot of useful and well-documented information, and timely market forecasts. In addition, Prechter is right when he says that when manias come to an end, prices tend to retreat to where the mania started. So, from this point of view, a Dow Jones decline to around 1,000 should not be excluded (see Figure 4). Also, in the course of my life I have seen numerous asset markets decline to the level where the bull market started. Ninety percent declines in asset markets are not all that uncommon! I also sympathise with Prechter's view that there will one day be a complete credit collapse, or, as he writes, “an

80%–90% decline in the volume of dollar-denominated credits worldwide”. But, where I have some issues with Prechter is on the timing of this credit implosion and whether, as he writes, “surviving dollars and dollar credits ... will rise in value”.

To start with, and based on fiscal and monetary policies of the last 30 years, it is likely that if the Dow were to decline by more than 20% from the present level there would be further massive fiscal and monetary stimulus packages — not just in the US but worldwide. These economic policy measures would likely fail to boost economic activity in the US but could support asset markets. (See GBD report of March 3, 2010 entitled “The Great Reflation”, in which I discussed the performance of Mexican stocks between 1978 and 1988 during the Latin American hyperinflation.) Albert Einstein defined “insanity” as “doing the same thing over and over again and

expecting different results”, but this is exactly what governments and central bankers will do in terms of economic policies should the Prechter scenario of a debt collapse and the Dow below 1,000 approach. So, before the final collapse unfolds, there should be another wave of enormous monetary inflation (an increase in the quantity of money).

I am aware that Prechter and economists such as David Rosenberg and Gary Shilling are convinced that their deflation scenarios are unfolding *now*. But, as I have explained in earlier reports, whereas in the US there could be pockets of deflation, the reality is that there are inflationary pressures in emerging economies. In Thailand, egg prices have just increased by more than 50% because of a drought. And, as an aside, grain prices in the US have recently soared (see Figure 5). So, until I see more evidence of the 80% or so debt contraction that Prechter is expecting, I think the likelihood of the Dow going below 1,000 and of widespread deflation is remote.

But I have the biggest problem with Prechter’s view that “surviving dollars and dollar credits, representing the denominator of the DJIA, will rise in value, and the Dow — along with everything else not used as money — will fall in dollar price”. The question here is really, with the Dow Jones below 1,000,

what kind of dollars — and especially, what kind of dollar credits — *will survive*. Maybe cash dollar bank notes stashed under your mattress. But with the Dow below 1,000 and an 80% credit contraction, it is safe to assume that almost all the banks in the world, and almost all the governments, will be bust. So, under these conditions, it might be safer to own some well-managed companies that have low leverage, rather than most forms of cash and cash-similar investments (bank deposits, CDs, commercial paper, Treasuries, money market funds, etc.).

I am not implying that it would be impossible for the Dow to go below 1,000, but just that it is not very likely. If you think it through, an investor might be better off in stocks that decline temporarily by 90%, rather than in cash deposits and bonds, which won’t be repaid at all.

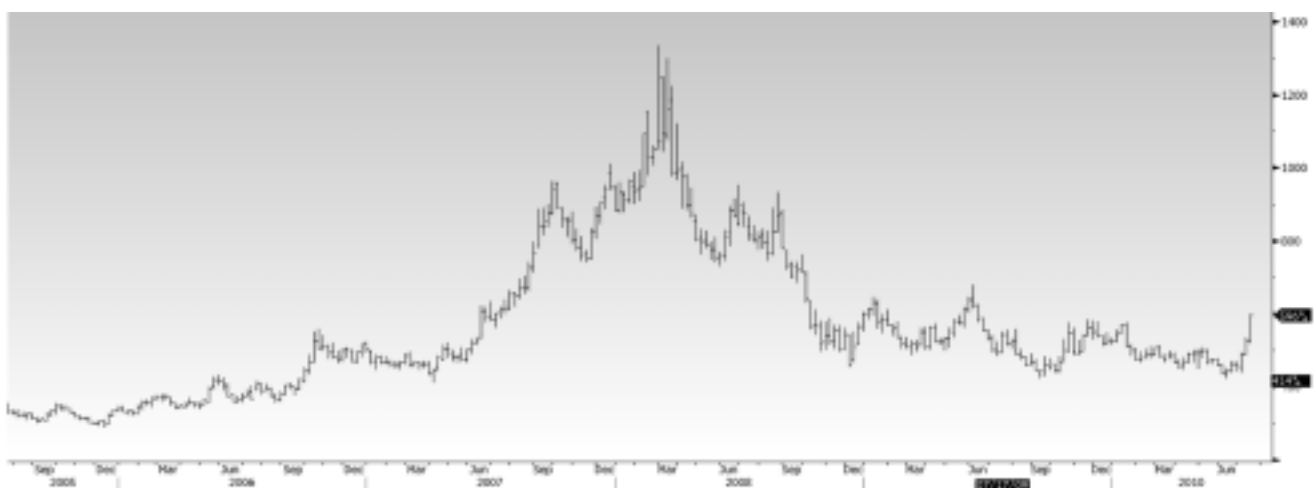
Also, as I have pointed out in previous reports, I am not sure that paper currencies are a reliable unit of account any longer. I could postulate that in gold terms the Dow Jones has already declined by more than 70% (see Figure 6). I could then further argue that, in a complete credit collapse, gold prices would decline to, say, US\$300, although this is far from certain because the leveraged players in the gold market are more likely to be the shorts than the longs who hold physical gold fully paid as a substitute

for cash. But let us assume the Dow is below 777 (or even below 572), as Prechter suggests (see above), based on his wave counts, and gold is at US\$300. An investor will still be much better off in gold than in equities, and bonds and deposits, which won’t be repaid in the 80% credit contraction.

I should also mention that with the Dow below 1,000, no pension fund (private or public) will pay any benefits and most insurance companies will be out of business.... Moreover, Reich’s “mad-as-hell populace” will “take back America” through a nice little civil war, the looting of retailers, and the burning of Washington and Wall Street.

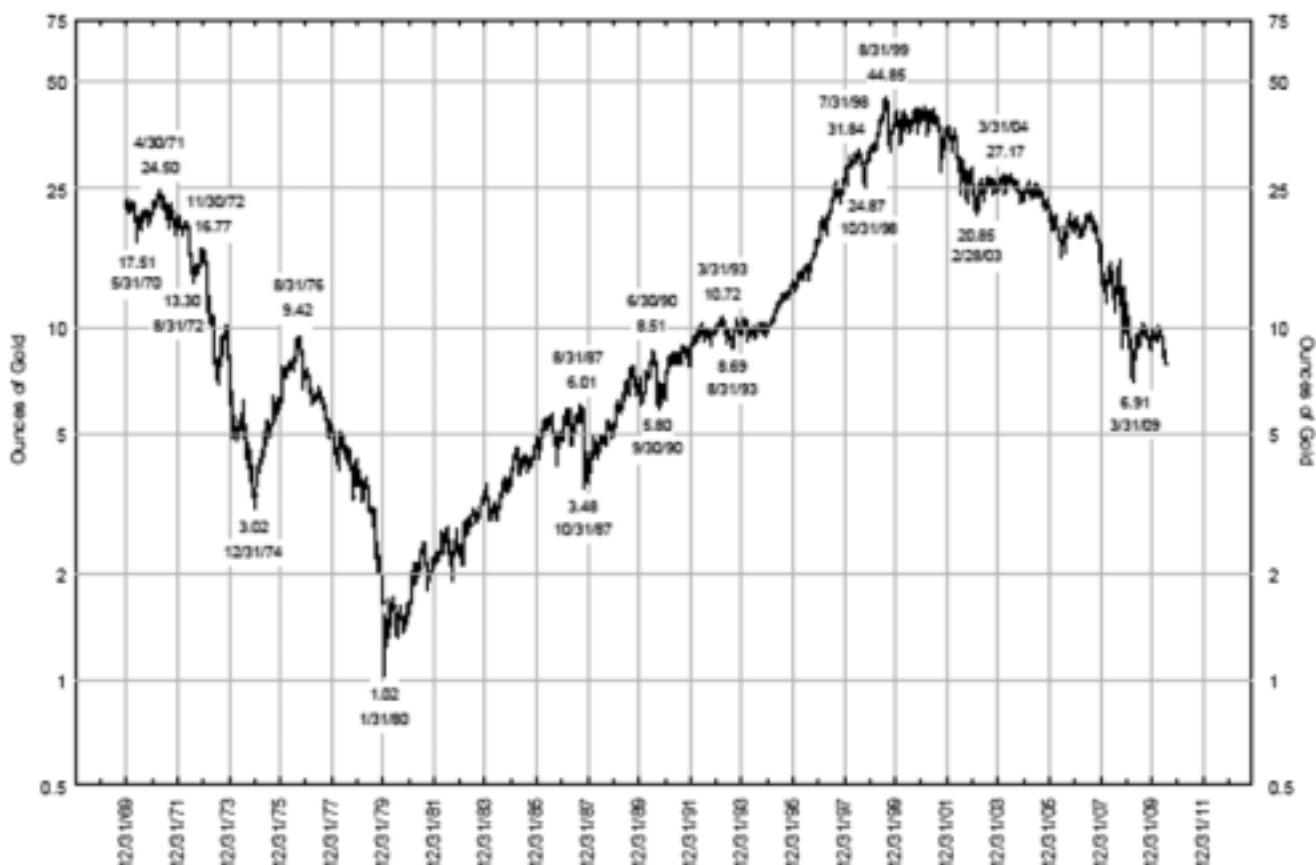
Once again, I want my readers to think very carefully about the implications of a Dow below 1,000 (or even just below 5,000). Does anyone really think that the money printing presses won’t run 24 hours a day? For sure, I don’t. Also, under the Dow below 1,000 scenario, a major war becomes a high probability. Ernest Hemingway observed, “The first panacea for a mismanaged nation is inflation of the currency; the second is war. Both bring a temporary prosperity; both bring permanent ruin.” But would a major confrontation drive the stock market down? Given the current government debt level and the present fiscal deficits, any escalation of military

Figure 5 **Wheat Prices (USD/bu.), 2005–2010**



Source: Bloomberg

Figure 6 **In Gold Terms, the Dow Jones is Already Down by More than 70% — Dow Jones Industrials/Gold Ratio, 1969–2010**



Source: Ron Griess, www.thechartstore.com

expenditures would be highly inflationary. So, even under these rather somber conditions, a Dow below 1,000 would not be probable.

## INVESTMENT OBSERVATIONS

I need to point out that even if I believed in a Dow below 1,000, I would find it very difficult to implement an investment strategy that would be guaranteed to protect my modest wealth. I suppose that a self-sustainable farm in the middle of nowhere surrounded by high-voltage fences and barbed wire, and equipped with booby traps and an arsenal of machine guns, hand grenades, and armed vehicles, and guarded by vicious Dobermans, would offer some personal protection, but with the Dow below 1,000 the value of such an estate would also likely decline. But at least a farm — maybe on a remote island and not necessarily

equipped as I have just described — would allow you to survive from the produce of the land; whereas if the scenario of the Dow below 1,000 were to materialise, life in the cities might become very dangerous, as I explained above. Also, even with the Dow below 1,000, theoretically the value of the farm could go up. That would depend on the number of urban residents looking to move to the countryside to seek refuge from the civil strife that would make life in the cities very difficult. It would also depend on the price movement of agricultural commodities, which could soar as a result of climatic changes and water shortages. (See below the report by Bill Leavitt.)

You and I could buy some insurance against the Dow Jones moving below 1,000, but this would be of little use for a large pension or endowment fund. Sure, they could buy farm and timberland, but, as I

have indicated, with the Dow below 1,000 the value of these holdings would also likely decline.

One way to protect assets could, of course, involve short selling — in the absence of cash and bonds being “safe” with the Dow below 1,000. (As explained above, massive defaults would occur.) A \$1 billion portfolio could sell short its holdings “against the box” (meaning that, for the exact same shares the portfolio is long, equal short positions would be maintained). With the Dow below 1,000, even if no transactions get settled, the portfolio would have been fully protected. However, with the Dow on its journey to 1,000, short selling will likely be banned and short positions will have to be closed out — so, again, there is no full protection.

There is another point I wish to make about the practical implementation of a strategy based

on the Dow being below 1,000. Before the Dow embarks on its journey to 1,000, it could first increase to 20,000, 100,000, or even higher if sufficient money is printed. In this scenario, the Dow might go below 1,000 in the context of a currency reform whereby for each old \$100, \$1,000, or \$100,000 bill (I am certain that these large-denomination bills will be introduced in the future), you will get just one new dollar. What I wish to show is that betting on the Dow going below 1,000 also entails some very high risks, because it may not happen at all and if it does happen, it may

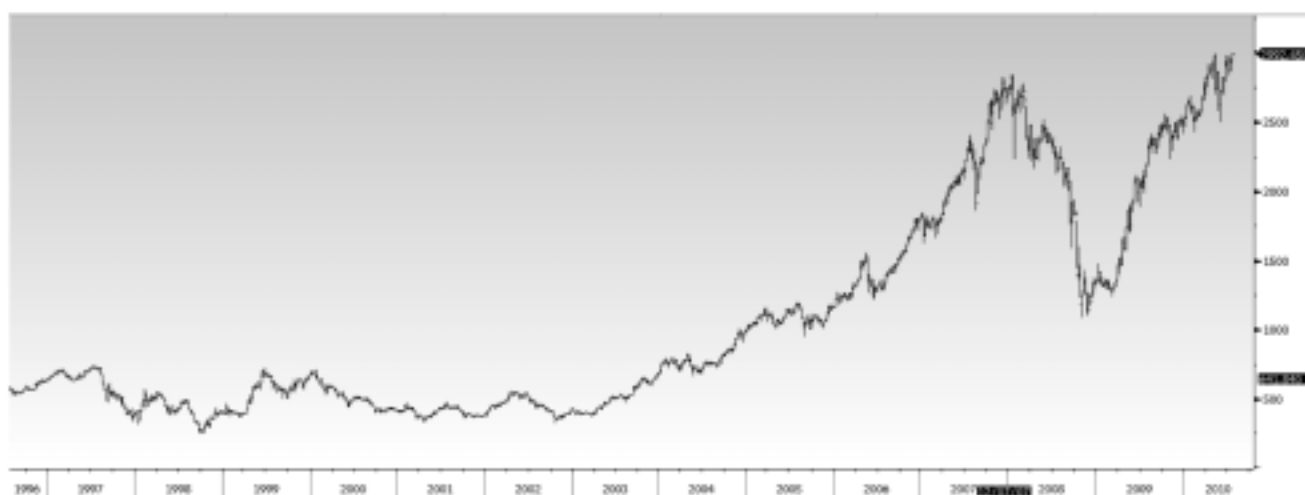
possibly be after further sharp gains first.

As my readers know from earlier reports, it would be difficult to find anyone more negative than I am about everything. I truly think we are all toast. But if I look at the last 200 years or so of capitalistic history, during calamitous periods such as the Dow below 1,000 would bring about, investors in **diversified** equity, real estate, and precious metals holdings (also art, stamps, etc.) tended to do better than those just in cash and bonds. Sure, stocks, precious metals, bonds, farmland, art prices, etc., would decline in value, but you

would still own some of them. (Some might be expropriated; hence my emphasis on diversification, including geographical diversification.) But in periods of great economic and political stress (hyperinflation, depressions, wars, civil strife), bond and cash holders usually lost everything through bankruptcies and defaults, or through a complete decline in the purchasing power of money.

Some of my readers might be too young to remember, but in 1997–1998 we had in Asia a once-in-a-lifetime economic crisis. Everything collapsed: real estate, stocks, and

Figure 7 **Jakarta Stock Price Index (in Indonesian Rupiah), 1996–2010**



Source: Bloomberg

Figure 8 **Jakarta Stock Price Index (in US Dollars), 1996–2010**



Source: Bloomberg

currencies. One of the hardest-hit countries was Indonesia (see Figure 7). Between the summer of 1997 and September 1998, the Jakarta Stock Price Index dropped by 65%. But, the damage in US dollar terms was far larger, because the Indonesian Rupiah collapsed against the US dollar. So, in dollar terms, the index dropped by 92%, which would fully satisfy the qualification for a Supercycle bear market à la Prechter (see Figure 8). But look at what has happened since! In local currency terms, the Indonesian stock market is now four times higher than it was at its 1997 peak (see Figure 7). In fact, the 1997–1998 bear market is hardly visible on a long-term index chart. And in dollar terms the Jakarta Stock Price Index has just marginally exceeded its 1997 peak (see Figure 8).

Now, I am not suggesting that it was a pleasant picnic for investors to endure the 1997–1998 crisis, but over time they recouped their losses. But this was not the case for many lenders and buyers of Indonesian corporate bonds denominated in the Indonesian Rupiah, which is still down by about 70% from its pre-1997 crisis level (see Figure 9).

The other point I wish to reiterate is that, in 1997–1998, the Indonesian stock market collapsed by 65% in local currency terms. Part of the credit meltdown led the Indonesian Rupiah to collapse (see Figure 9). So,

in US dollar terms we had a 92% bear market. Now, I would imagine under a Prechter scenario something similar could happen in the US. From their October 2007 peak to their March 2009 lows, both the S&P 500 and the Dow Jones dropped by around 55%. A 65% decline would take the S&P down to around 550. But to fulfil the Prechter price target (of a minimum 90% price decline), the rest of the decline could be absorbed by a US dollar collapse (say, against gold). In other words, as explained above, the US stock market could, over time, continue to decline against the price of gold, as it has since 1999 (see Figure 6). This would seem to me to be the most likely outcome.

Over the last few weeks, I have received the following stock recommendations from brokerage firms: “Glow Energy (GLOW TB): we estimate Q2 earnings of Bt 1.3 bn, up 20% Y/Y.... By FY12, GLOW capacity will increase 50% ... (earnings will double).... We recommend Buy for GLOW supported by increasing volume sales growth and **good dividends of 6% in FY10, 7% in FY11 and 10% in FY12.**”

“Thai Tap Water (TTW TB) is enjoying both rising selling prices via higher inflation and increased sales volume from strong food exports. It also offers a very high FCF yield of

12–16% in 2010–11F. Having underperformed the SET by 24%, TTW is a laggard play **with a high dividend yield of 7.5–8.3% in 2010–11F. Maintain BUY.**”

“Parkway Life REIT (PREIT SP) posted a good set of results for 1Q10 and declared a dividend per unit of 2.07 cents. Gross revenues increased by 14.1% y-o-y ... while income grew by 9.7% y-o-y.... With low gearing of 28.2% and strong debt headroom, we see potentially accretive acquisitions in the developed markets as catalysts. **Maintain Buy**” (stock yields almost 6% in Singapore dollars).

Or consider the following Singapore REIT dividend yield statistics: Ascendas REIT (AREIT SP): 6.8%; CapitaCommercial Trust (CCT SP): 5.6%; CapitaMall Trust (CT SP): 5%; CapitaRetail China Trust (CRCT): 6.8%; CDL Hospitality Trust (CDREIT SP): 5.5%; Fraser Centrepoint Trust (FCT): 6.1%; Mapletree Logistic Trust (MLT SP): 6.7%; Suntec REIT (SUN SP): 6.1%.

Now, I wish to emphasise that I am not necessarily recommending that my readers buy these stocks. (I happen to own the shares — and most of the REITS — listed above, among many others.) But I want readers of this report to consider what they would prefer to own in the long term: ten-year US government notes yielding less than 3%, or the

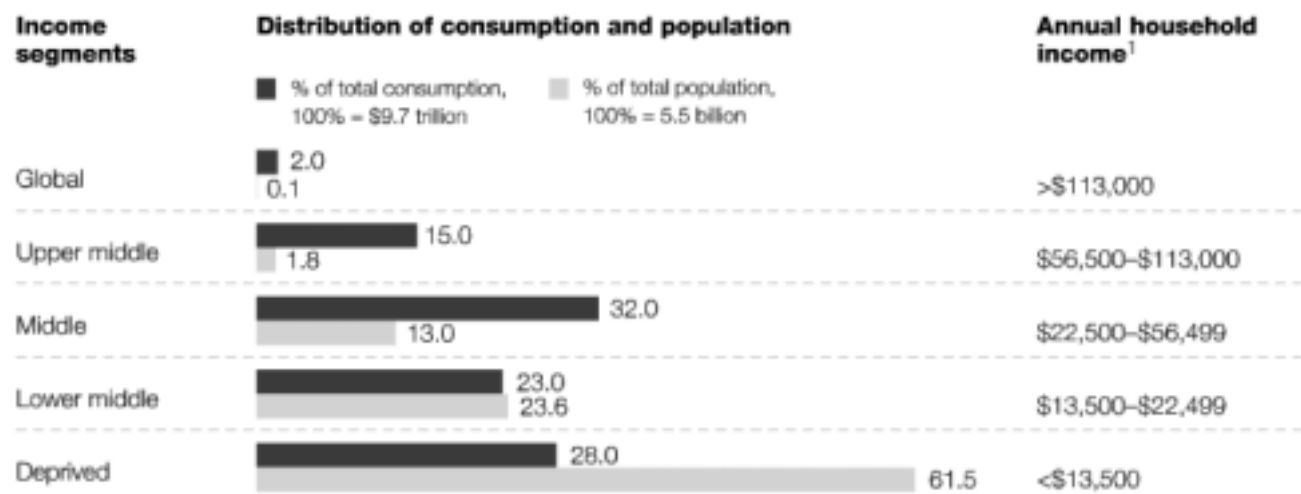
Figure 9 Indonesian Rupiah, 1996–2010



Source: Bloomberg

Figure 10 **At Least Some Good News**

**In developing countries, the emerging class—nearly two billion strong—spends a total of \$6.9 trillion annually.**



<sup>1</sup>Based on purchasing-power-adjusted exchange rate.

Note: Developing countries are Argentina, Brazil, Chile, China, Colombia, Egypt, India, Indonesia, Iran, Malaysia, Mexico, Nigeria, Pakistan, Peru, the Philippines, Poland, Romania, Russia, South Africa, Thailand, Turkey, Ukraine, Venezuela, Vietnam.

Source: Economist Intelligence Unit, June 2009; Euromonitor, June 2009; World Bank, April 2009; McKinsey analysis

Source: McKinsey Analysis

companies mentioned above, with a dividend yield of 6% or more? Or would they prefer to own cash at essentially zero interest, with the prospect that interest rates will stay below zero in real terms for a very long time to come?

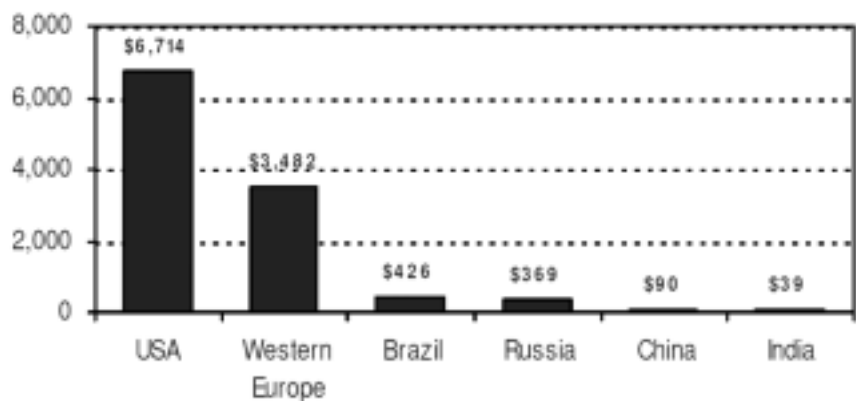
I don't know! Maybe Prechter is right, and I'm not bearish enough (although, as I have explained in earlier reports, I did take some money off the table). But the fact remains that the Asian portfolios I look after, and the ones some of my fund manager friends look after, are all significantly up on their pre-2008 crisis levels — well understood after having performed well between 2003 and the 2007 peak.

There is another point that the Superbears in the US are overlooking. Whereas it is partially correct that in the US, as Reich says, “the rest don't have enough purchasing power to buy what the economy is capable of producing”, a huge new middle class of about two billion people with a combined spending power of US\$6.9 trillion

has emerged in the emerging world (see Figure 10). According to McKinsey, “the rapidly growing ranks of middle-class consumers span a dozen emerging nations, not just the fast-growing BRIC countries, and include almost two billion people, spending a total of \$6.9 trillion annually. Our research suggests that this figure will rise to \$20 trillion during the next decade — about twice

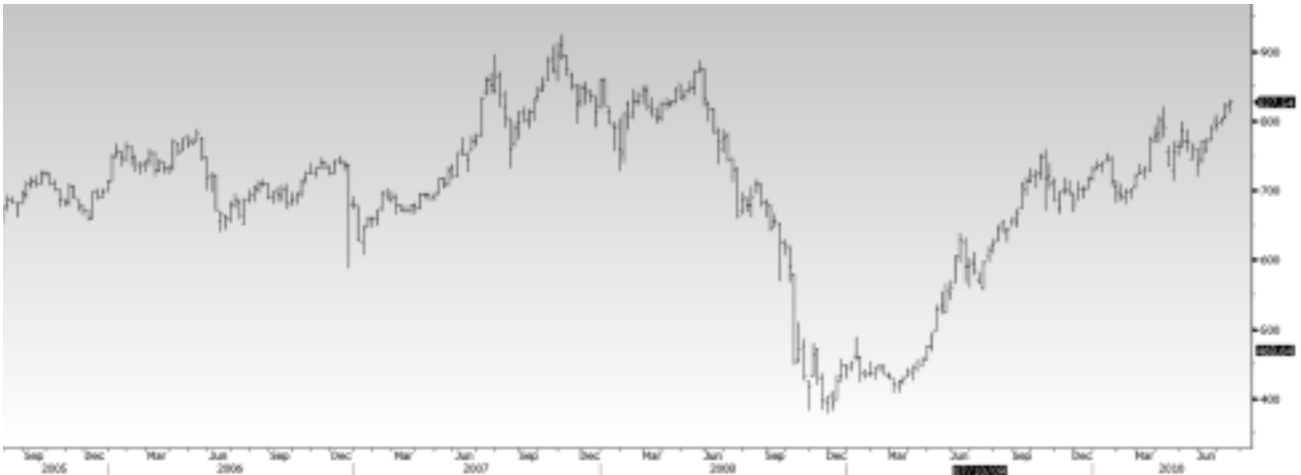
the current consumption in the United States.” McKinsey may be erring on the side of optimism, but my impression is certainly that consumption in the emerging economies will continue to increase over time. Take as an example per capita expenditures on healthcare. In emerging economies it is still so low that an increase over time is almost inevitable (see Figure 11).

Figure 11 **Per Capita Total Health Spending, 2006 (in US\$)**



Source: WHO, www.sectoral.com

Figure 12 **Bangkok SET Index, 2005–2010**



Source: Bloomberg

So, whereas I can see that lower standards of living in the US and in Western Europe will force people in those parts of the world to moderate their spending habits, I find it difficult to envision a complete collapse in emerging economies. This is not to say that recessions in countries such as China, India, and Brazil are impossible, but a complete collapse...? It's hard for me to imagine such a scenario. Take, as an example, Thailand. We almost had a civil war and the economy took a temporary hit. But consumption has recovered (car sales in June were very strong) and, surprisingly, the stock market has just made a new high (see Figure 12). Incidentally, the Thai stock market is up by more than 12% so far this year and is approaching its 2007 high.

So, I think that perhaps the best strategy is to take neither an extremely positive stance towards asset markets (S&P 1,350 by year end), nor an extremely Prechter type of negative approach, but to assume for the time being that the March 2009 lows will hold and that new stock market recovery highs above 1,219 for the S&P 500 (reached on April 26 of this year) are unlikely in the second half of this year (see Figure 13). Equally, an imminent stock market crash is unlikely because sentiment is again rather bearish (see Figure 14).

So, I recommend avoiding vulnerable sectors such as consumer durables, credit card companies, and retailers (see Figure 15). Remarkably, the Retail Holders (RTH), which includes retailers such as Wal-Mart (WMT), Home Depot (HD), Amazon.com (AMZN), Target (TGT), and Lowe's (LOW), made a new high in 2010 above the 2007 high. At the same time, as indicated above, one of the few sectors of

extremely positive price action is the agricultural sector (see Figure 5), including also soft commodities such as sugar, coffee, and cocoa. As mentioned in previous reports, I find it difficult to play agricultural commodities except through the futures market, or through plantation and similar companies such as Sprott Resources (SCP CN), Cresud (CRESY), and Univanich Palm Oil (UVAN TB), or potash, fertiliser,

Figure 13 **S&P 500, 2008–2010**



Source: www.decisionpoint.com

Figure 14 **Bulls-to-Bears Ratio, 1998–2010**



Source: Ed Yardeni, www.yardeni.com, www.investorsintelligence.com

Figure 15 **Avoid US Retailers**



Source: www.decisionpoint.com

I am pleased to enclose two reports below, both of which are highly recommended. First, Richard Lawrence (rlawrence@overlookinv.com), CEO of Overlook Investment, Inc. and a friend of mine for more than 25 years, writes that the principal “tangible benefits of Overlook’s business philosophy have been dominated by our Cap on Subscriptions (the ‘Cap’). This decision in 1992 to institute a Cap, more than any other decision throughout the history of Overlook, has produced quantifiable benefits for all limited partners.”

According to Richard, Capital Weighted Return (CWR) “calculates the dollar weighted Internal Rate of Return for the average investor in the fund. **It is not one specific investor’s return, but rather an average measure of the actual return earned collectively by all investors in the fund.** The CWR accounts for all cash flows into and out of the fund to measure how the average investor performed over time. This number almost never appears in public”, for reasons Richard explores in his really fascinating report (emphasis added). I should add that I am a very happy investor in Richard’s fund, but that I don’t entirely agree with all the points he makes in his report. If investors decided to buy into high-tech funds at the peak of the Nasdaq

and providers of seed and genomic product companies such as Swiss-based Syngenta AG (SYNN VX) and Monsanto (MON — see Figure 16). For a short-term trade, the PowerShare DB Multi-sector Commodity Trust Agriculture Fund (DBA) could be considered (see Figure 17).

As mentioned in the July GBD report, it is likely that the S&P 500

will decline to between 870 and 950 in September or October. Therefore, I would lean towards reducing equity positions on rebounds, rather than increasing them aggressively. I am also concerned that gold could come under some pressure. A decline to US\$950 per ounce would not surprise me. (However, I continue to accumulate gold.)

Figure 16 **Monsanto, 2006–2010**



Source: www.decisionpoint.com

Figure 17 **Agriculture: One of the Few Strong Sectors**



Source: www.decisionpoint.com

in late 1999 and early 2000, a “Cap” on one fund would not have deterred these investors from investing in other existing or new high-tech funds. Still, Richard makes some very good points that should give an investor plenty to think about.

Further below, William (Bill) Leavitt (wleavitt@leavittcapital.com), an expert on water, writes about water and energy. Leavitt is the president of Leavitt Capital, Inc., a registered investment advisory firm established in 1985. His firm

specialises in identifying and investing in unique investments, affording wealthy families and institutions exposure to a multitude of opportunities, including water, food, agriculture, energy, environmental solutions, and timber, among others. Leavitt’s research has taken him to virtually all corners of the world, including sugarcane ethanol plants and cattle ranches in rural Brazil, timber harvesting sites in New Zealand, and manufacturing facilities in Vietnam, Ukraine, Africa, and China. As many of the water opportunities mentioned in his article are small, private, and require a great deal of travel and research, his firm has created a Global Water Opportunities Fund, as well as water advisory relationships, to assist investors interested in capitalising on water investments. I asked Bill about investment opportunities in his space and he responded as follows:

Marc — we do not think the optimal manner is to invest in water ETFs or to attempt to find public equities. The public equity market is very well covered and has become pretty efficient. The best opportunities are private, and when they grow (hopefully with our investment), they are often acquired by giants like GE, Siemens, Keppel, and other behemoths, who dominate the space. Water, however, accounts for little of the revenues and profits of these large companies. Opportunities like water rights (in the western U.S. and Australia) are a complete private market, with very particular specialists. Expertise is required to understand U.S. Water law, to make sure one is actually buying a water right (which may be acquired separately from the appurtenant land), whether the rights [are] junior or senior to other rights, etc. In Australia, the water rights market is regulated by the government and is very efficient, except that prices tend to move inversely with rain, so opportunities exist for traders. Water storage in the U.S. and any

country is largely accomplished through private transactions. It is a growing area, and one in which we are very interested. For example, 90% of India's annual rainfall occurs in a 90–120 hour period. Ten percent of Mexico City's annual rain might occur in one event. If Mexico, India or Bangladesh (the most typhoon prone country in the world) built large, cavernous reservoirs (which is not uncommon in the U.S., and

in which we invest), to collect and trap some of the rain (this is called catchment), which otherwise just washes out to the sea, some of the drought conditions in these areas could be alleviated. These are just some of the opportunities in this exciting area.

As a water play, I own Thai Tap Water (TTW TB), Hyflux (HYF SP), and Hyflux Water Trust (HYFT SP). The only point I should like to add is

that water diversion from rivers will add to significant geopolitical tensions between different countries. India is accusing China of diverting water from the Brahmaputra, and Laos, Vietnam, Cambodia, and Thailand are accusing China of hijacking water from the Mekong River. Egypt and Sudan are very concerned that East African countries will divert water from the Nile. Oil, water, and food are likely to increase international tensions greatly!

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## Quarter in Review

Richard Lawrence, CEO, Overlook Investment, Inc., E-mail: rlawrence@overlookinv.com

I am delighted to report that the Partnership recorded an advance of 3.13% in the month of June, 2.75% in the second quarter and 15.65% year to date. These numbers continue to run substantially ahead of the benchmark, which has recorded a drop of 5.62% year to date.

The second quarter brought us the European Crisis with severe disequilibrium uncovered for the world to see. The crisis in Europe should have a modest negative impact on Asia's growth. However, Overlook's view is that Asia continues to avoid many of the root problems that exist in Europe and the US. In an event that must seem almost unfathomable for Europeans and Americans, Taiwan cut its corporate tax rate and reached an agreement on a trade liberalization deal with China. This is not to say that one can straight-line Asia's success and we can only hope that the problems of the developed world will serve as a useful reminder for Asian government officials of misguided economic policies.

As is my custom, I will be on the East Coast in late July and will post an updated presentation on the portfolio by the end of the month. If you would like to attend Overlook's Group Meeting on Tuesday, July 27<sup>th</sup> in New York City please send me an e-mail and I will make sure that you get an invite.

### ONE OF WALL STREET'S DIRTY LITTLE SECRETS

This quarter's letter represents a change in our normal format of discussing one of our major investments with you. This report is the first time I have ever written to you on the subject of performance, a topic I have been hesitant to touch given that I am paranoid that the mere mention of Overlook's performance could be the kiss of death, especially following such an extended period of out-performance, experienced since July 2007.

However, please rest assured that the subject of this quarter's letter is not about Overlook's recent performance, but about a specific lesson for Overlook's investors that has emerged from Overlook's 18-1/2-year track record. Quite amazingly, it is a discovery that has evaded my detection for nearly all of these years.

There is a common saying in the industry that "size is the enemy of performance." I hope to show that it would be more accurate to say that "fast asset growth and greedy business philosophies are the enemies of performance."

### Setting the Stage

My introduction to performance analysis came 28 years ago when I was studying Level 1 of the CFA

exam. Roger Ibbotson's research on long-term rates of return for small, medium and large cap equities was part of the CFA required reading. When I established Overlook, I never told anyone that Roger Ibbotson's long-term result figures were my target performance returns, but they were and always have been. Courtesy of my friend Bill Hutchinson of Hutchinson Capital, the latest geometric performance figures from 1926 to 2008 from Ibbotson Associates are as follows:

Small Cap Stocks	11.7%
Large Cap Stocks	9.6%
L.T. Government Bonds	5.7%
Inflation	3.0%

Shortly after Overlook's inception, a rather stern, and now former client of mine, requested that I include Capital Weighted Return ("CWR") figures in our monthly statements. Not knowing better, I naively added this information and have provided all limited partners with individual and Partnership CWR information in monthly and quarterly reports ever since. I have always liked the fact that Overlook provides each investor with the results of their specific investment from their inception with Overlook. As someone who is married to a former advertising executive, I feel it

is a good example of truth in advertising. Investors are happy with Overlook, or they are not. But, either way, their own personal performance is absolutely clear.

Fifteen years ago I began to visit sophisticated institutional clients who spoke of performance with a vocabulary I didn't really understand. At that time I decided it would be best to leave the subject of performance analysis to them, and focus my energy on investing correctly in Asia.

Around 2005, 14 years into Overlook, the long-term compound performance numbers at Overlook recovered from the disaster of the 97/98 Asian Crisis and began to fit into the pattern that I had hoped for ever since my days of reading Roger Ibbotson. At last, I felt Overlook was justifying its existence. When I started Overlook in 1991, I never expected it would take me 14 years to establish a successful track record, but it did. But now, of course, I realize that few fund managers rarely operate a single fund exclusively for 14 years, let alone 18-1/2 years.

So this brings me to 2010, when a certain aspect of Overlook's performance history smacked me in the face, highlighting an incredibly important lesson about performance and investing. And I wanted to share with you my discovery in this piece that I have titled "One of Wall Street's Dirty Little Secrets."

Hedge fund managers and other aggressive asset gatherers might prefer to stop reading now as my story and my opinions may not be appreciated.

## Overlook's Investment and Business Philosophies

Many of you have heard me say in meetings that two components need to work together toward a common goal for a fund management company to become a great fund management company: an Investment Philosophy and a Business Philosophy.

After 18-1/2 years of running Overlook I can confidently inform you that disciplined and consistent execution of Overlook's investment philosophy has produced real value added for investors. Overlook, after

all expenses and performance fees, has compounded at 12.33% for 18-1/2 years, compared to the benchmark MSCI Far East ex Japan (Price) Index which has compounded at 4.85% per year since inception, and had lower volatility than the benchmark. Overlook has also beaten Roger Ibbotson's long-term performance figures. I believe these results are a reflection of the success of Overlook's investment philosophy and our dedication to it.

I also conclude that Overlook's business philosophy has been a big contributor to our success. The business philosophy is comprised of policies, procedures and disciplines that are less quantifiable than our investment philosophy, but which are equally important. We cut our management fees regularly; we outlaw policies that lead to conflicts of interest such as soft dollar brokerage arrangements; we work at intelligent transparency; we keep ownership within the four walls of Overlook; we keep a low profile; we seek to attract high-quality investors who share our vision; and most importantly we do not stray from our investment philosophy. The idea has always been to align the interests of the limited partners with the general partner so that Overlook can be a true long-term investor.

However, the tangible benefits of Overlook's business philosophy have been dominated by our Cap on Subscriptions (the "Cap"). This decision in 1992 to institute a Cap, more than any other decision throughout the history of Overlook, has produced quantifiable benefits for all limited partners. And it is the Cap that is the hero of my story today.

## First Our Story Needs Some Definitions

- *Time Weighted Return* ("TWR"): This calculates the compound growth of NAV/Share for an investment vehicle. When you open up newspapers this is the number you see advertised.

- *Capital Weighted Return* ("CWR"): This calculates the dollar weighted Internal Rate of Return for the average investor in the fund. It is

not one specific investor's return, but rather an average measure of the actual return earned collectively by all investors in the fund. The CWR accounts for all cash flows into and out of the fund to measure how the average investor performed over time. This number almost never appears in public for reasons we will explore later.

- *The Discount (the "Discount") and the Premium*: This is the difference between the TWR and the CWR for specific funds. Discounts occur when CWRs underperform TWRs.

## Studies on Time and Capital Weighted Returns and the Discount

The fact that CWR underperforms TWR for most funds is well established and, as such, is widely recognized as a problem for investors.

I first came across the Discount when I read a research study in the early 1980s about the Magellan Fund and Peter Lynch, one of my heroes. The report showed (and I can't remember the specific numbers or find the actual study) that while Peter Lynch was producing world-leading returns at Magellan, underlying investors actually performed far worse.

David Swensen of the Yale Investment Office has also highlighted the Discount suffered by investors in tech mutual funds during the Internet bubble in his entertaining chapter titled "Chasing Performance" in his book *Unconventional Success*.

Jack Bogle of Vanguard has written extensively about the Discount as well. In his recent book, *Enough*, Mr. Bogle opined that CWRs trailed TWRs in the indices on average by 5 percentage points per year over 25 years leading up to 2005.

Recently, the CGM Focus Fund, managed by Ken Heebner, has been named the "best-performing U.S. diversified stock mutual fund of the decade" by Morningstar. According to the *Wall Street Journal*, the CGM Focus Fund has produced TWRs of 18% over the past 10 years. Yet Morningstar showed that, on average, underlying investors actually lost

11% per year by year ending November 2009. This is a Discount equal to 29 percentage points on average every year for a decade! In other words the average investor actually lost money after investing with the “best-performing U.S. diversified stock mutual fund!”

### Why the Discount?

There are two principal causes of the Discount.

First, a fund manager can generate exceptional results as measured by TWRs at the inception of the fund when assets under management (“AUM”) are small. Then the manager gets “discovered” and/or “promoted” and an explosion of money enters the fund, to the great delight of the fund manager. However, with the larger asset base, the now-famous fund manager performs poorly, dragging down his TWR, but crushing his CWR.

Second, CWRs are hurt by mistiming investments in funds. Investors chase funds and themes and then bail out when markets turn down. This behavior inevitably decreases their CWRs. But even buying smartly and selling poorly, or buying poorly and selling smartly, can result in a Discount. This is tough evidence in a world where we are told that we can’t time investments.

On average I believe that the Discount increases when some of the following conditions prevail:

- Funds experience fast growth of assets under management.
- Funds are invested in trendy asset classes, such as Russia a few years ago, tech stocks in the late 1990s, mega hedge funds in the past few years.
- Funds are exposed to excessive valuation risk.
- Funds have excessive exposure to fund of funds’ investors.
- Funds are operated in higher volatility sectors.

### How Much is the Discount?

If you invest Day 1 in a fund and exit when the fund closes, your TWR and CWR will be identical and the Discount will be zero. However, few of us make such investments.

For an asset class like Overlook’s (Asia ex Japan), I estimate that the Discount is somewhere between 4 and 9 percentage points per year, although some evidence I have found suggests it could be higher. To put this in perspective, if a fund is promoted in its marketing material as likely to earn an annual 12% compound TWR, then underlying investors would probably earn true average annual returns in the range of 3% to 8%.

### Who is Responsible?

Fund managers inevitably blame investors for both principal causes of the Discount. You can just hear them, can’t you? “I didn’t write the check.” “Fast growth of assets under management won’t impact my performance.” “I told the investor not to redeem at the bottom of the bear market.” “Yes, fund of funds’ investors comprise 45% of my assets under management, but they have made a long-term commitment.” “Yes, the fund has risen a lot but P/Es are still relatively cheap.”

I don’t buy these excuses and feel that individual fund managers, and the wider asset management industry, are complicit in the Discount and conveniently guilty of casually brushing off responsibility to manage, and be accountable for CWRs.

### Can the Discount be Eliminated?

Now here is where our depressing story gets more interesting.

While much has been written about the Discount, almost nothing that I have found has been written about the near-guaranteed ability of fund managers to eliminate the Discount. Yes, I did say “near-guaranteed ability of fund managers to eliminate the Discount.”

Overlook, as shown below, has eliminated the Discount over just about every time period from year 1 to year 18 (see chart below).

And after many months of searching for the reasons why Overlook has been able to eliminate the Discount, I finally have the answer. The elimination of Overlook’s Discount is exclusively due to its Cap on Subscriptions. In fact, there is no other plausible explanation.

This achievement is not due, as I first thought, to the success of our investment philosophy or the luck of our investors in timing their investments. Our investment philosophy has helped us achieve out-performance of our TWR vs. the benchmark, but it has had no impact on CWR. The luck of the investors is not a factor either, as our investors have added funds to Overlook consistently over time. No, the answer lies exclusively in the Cap because the Cap on Subscriptions has allowed funds to enter in a very steady manner over the past 18 years. And control over the growth of AUM is the key to eliminating the Discount.

I have found a few funds that show CWRs above their TWRs, but in just about every case there is an anomaly that explains such results. The most common one can be found in specific funds that had a large subscription relative to AUM, with near perfect timing. In these cases, the one disproportional subscription carried the CWR. Other anomalies are found in funds whose asset classes did very poorly at inception, yet the fund managed to survive until the asset class got trendy, capital poured into the fund, and the fund performed well. African funds reflect this anomaly in recent years.

	<b>Time-Weighted Returns (net of performance fees)</b>	<b>Capital-Weighted Returns (net of performance fees)</b>
Since Inception	12.33%	11.18%
10 Years	15.21%	15.47%
5 Years	16.25%	16.55%
3 Years	7.16%	9.40%
1 Year	44.91%	43.26%

## Why Don't All Fund Managers Eliminate the Discount?

Now here is where I become critical of the industry. Hedge fund managers and asset accumulators who didn't stop reading before should really stop reading now.

If the Cap allowed Overlook to eliminate the Discount, could all fund managers eliminate their own Discounts if they adopted both a legal cap on subscriptions and Overlook's business philosophy so as to hold growth of subscriptions consistently, and from inception, to approximately 8–9% per year? My answer is a resounding "Yes".

And if managers could deliver between 4 and 9 percentage points per year of additional performance for their investors by embracing the Cap, why on earth wouldn't they? Their clients would be loyal and their business would have an excellent long-term outlook. Well, as we all probably know, Wall Street and the fund management industry are incentivized around the accumulation of AUM and accumulation of their own wealth, not their clients' wealth or the generation of CWRs.

Whilst individual managers can deny this, we only need to look at how few managers report CWR to their investors. A few of my clients tell me that Overlook is one of the very few that disclose CWR figures. Many hedge fund managers can't let this data out, as it would expose promotion of their TWR performance as misleading and the conflict of interest between them and their investors as huge, if not nearly fraudulent. If you don't believe me, ask all your managers to e-mail you their CWR numbers. Just be forewarned that replies may be few

and far between. Again, I just don't buy this as acceptable behavior.

While the community of investment managers with Caps ("Cap Community") is almost certainly very small (I don't have access to such data or even know who my fellow brethren are) I would be willing to bet that a database of managers in the Cap Community would show far smaller Discounts than a similar group of hedge funds who have grown AUM aggressively and become household names.

## Is the Discount Dangerous to Limited Partners?

Let's be clear about one thing. Just because a fund has a CWR equal to its TWR does not guarantee success. In fact, Overlook has investors with CWRs below our 18-1/2 years' TWR. But the difference is that the Cap works to eliminate the negative impact of greed on our investors.

So while the Cap Community can offer no guarantees on TWRs, I have come to realize that funds with large Discounts pose real and material risks to investors. For example, in bear markets, a fund with a high Discount would surely be much more prone to high redemptions, and would expose investors to the cost of side pockets or redemption restrictions. Almost certainly, if we accumulated the data on all the funds that side-pocketed or restricted redemptions during 2008 and 2009, we would find that a disproportionately large percentage of the funds had what I call a "CWR problem." Or, in other words, a large Discount.

So I strongly believe that a large Discount is dangerous to investors' health, and that all investors should monitor this number for all their funds. And if your managers don't

supply the data, perhaps you need to consider the rationale of your investment.

## Who Has the Largest Discounts?

What really makes me mad is that it is very probable that some portion of the largest (read greedy) hedge fund managers have large Discounts despite positive TWRs. Here I am referring to the fast growing, high-profile 2 and 20 crowd that built their businesses on excellent TWRs when they were small, then happily took in all the big bucks when expansion of AUM followed. It is specifically this group of "performance-based" managers that works to keep their CWRs as a deep dark secret.

## Happy Ending — of Sorts

While fund managers do not voluntarily report CWR, the good news is that it is well within our capabilities to calculate the CWR. As a result, Overlook has created an Excel template to assist in calculating the CWR for any fund. Should you wish to receive the Excel template, kindly contact us at [admin@overlookinv.com](mailto:admin@overlookinv.com). I encourage everyone to use this template to discover if you are exposed to a "CWR problem."

In the meantime, we should all keep our fingers crossed that the Cap Community of fund managers gains a few more converts, as Caps are clearly not the enemy of performance and anything but a dirty little secret of Wall Street.

As always, I thank everyone for your continuous loyalty and support. If you have any questions about this report or other matters at Overlook, please do not hesitate to contact me directly.

# Water and Energy: A Dangerous Dance

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“Nothing is softer or more flexible than water, yet nothing can resist it.”

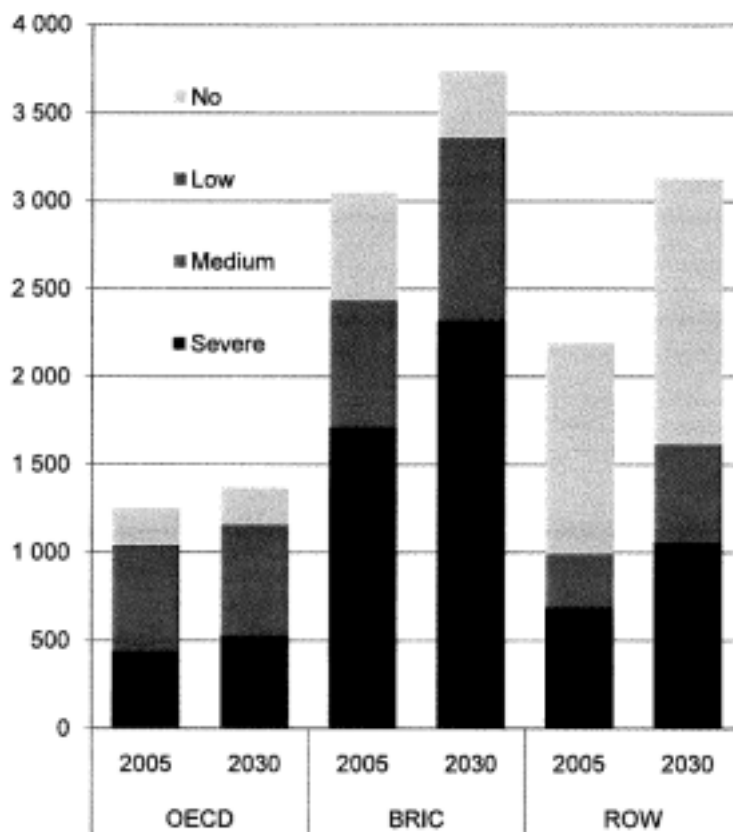
Lao Tzu, 600 B.C.

As waves of oil-fouled water lap at the U.S. Gulf coast, spoiling estuaries, beaches, marshes and wetlands, the media has bombarded us with pictures of dead fish, injured animals and birds. One is struck with the clash of offshore drilling and the ocean environment. In this article, we will address a larger issue, which includes offshore drilling — the conflict of energy and water.

In our previous article (“Water — Cycle of Life”, GBD report of September 1, 2009), we discussed the current issues of water scarcity and the looming water crisis (Chart A). Approximately 70% of water consumption is used for agriculture and 20% is used for industrial and energy usage. Demographers expect a 50% increase in global population (from 6 billion to 9 billion) over the next thirty years. Unfortunately, much of the water is in the wrong places. The imbalance of projected economic and population growth suggests that within twenty years, water requirements will be 40% greater than available supply (Chart B). In many developing nations, the shortage could reach 50%.<sup>1</sup> Recycling, conservation, desalination and new remediation technologies are the only answer.

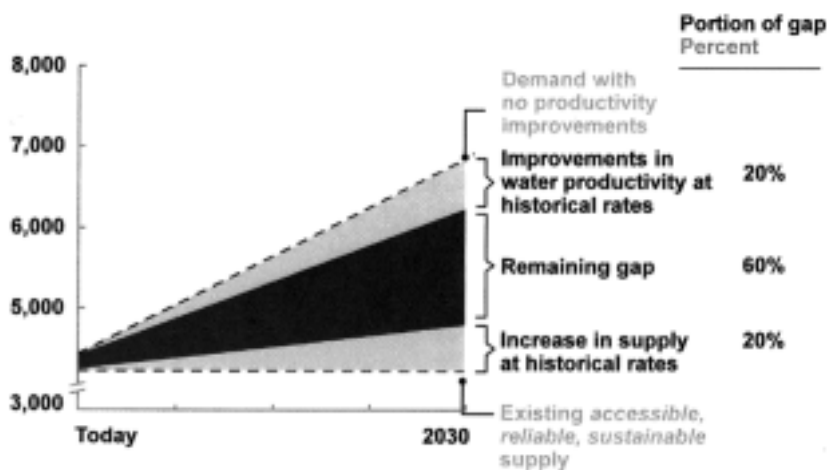
Energy and water are linked in a dangerous dance — water is a critical part of the operation and development of energy resources, while energy is an integral component of the transporting, pumping and processing of water. Demographic and economic growth, as well as social and technological advances, pressure both energy and water demand. While overall water

Chart A **Increasing Number of People Living in Areas of Water Stress**



Source: OECD

Chart B

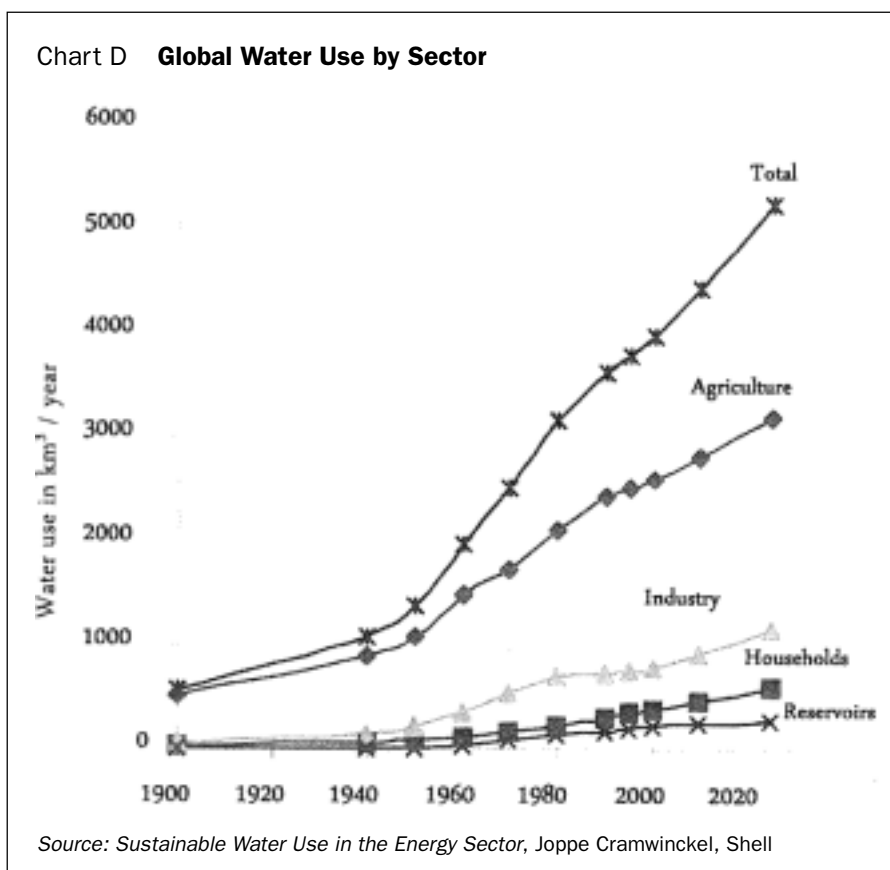
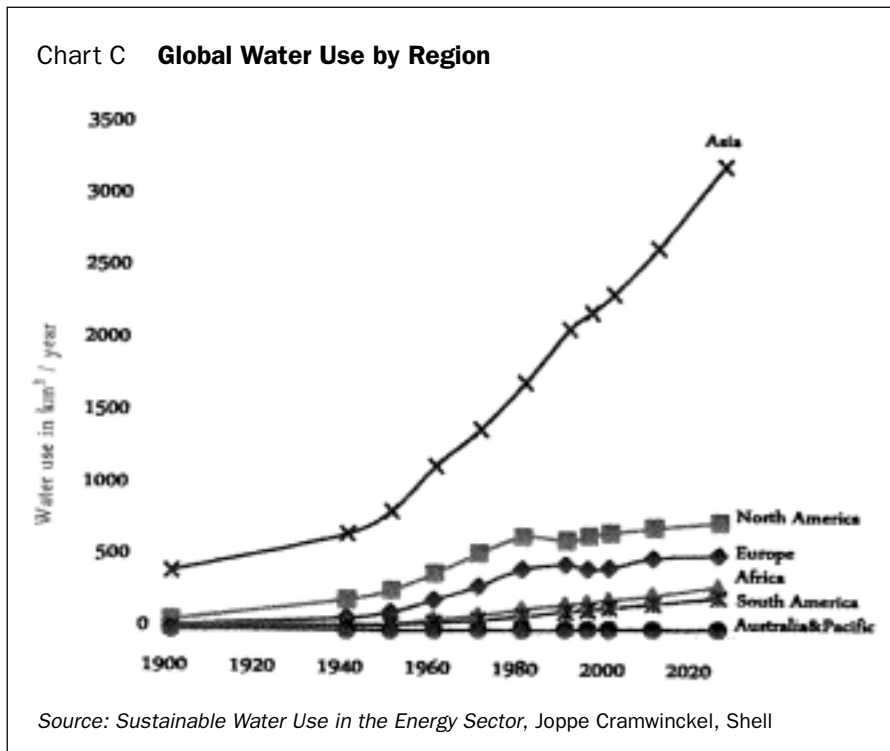


Source: *Charting our water future*, Usha Rao-Monari of the I.F.C.C & Dr. Giukio Bocaletti of McKinsey & Co.

use is increasing, usage in industrializing Asia is growing at the fastest pace (Chart C). While agriculture is and is still expected to be the largest component of water requirements, industrial usage and electrical generation is expected to grow at an alarming pace (Chart D). China's industrial and energy generation is predicted to increase by 3% per year, from 129 billion m<sup>3</sup> in 2005 to 265 billion m<sup>3</sup> in 2030.<sup>2</sup>

The conflict between energy and water, as evidenced by the Gulf spill, arises from the increasing demand for energy around the world. Even traditional oil and gas drilling are water intensive. Depending on location, it can take forty gallons of water to extract one gallon of oil. At the refining stage, approximately 22 liters of process water are required for every refined liter of oil.<sup>3</sup> The hunt for additional sources of fossil fuels has sparked the need to access unconventional gas and oil reserves. Existing offshore drilling is only one example — we have seen the consequences of current drilling depths, and some proposed offshore drilling would be at depths three to five times that of the BP well. Extraction of oil from tar and oil sands requires massive amounts of energy and water.

The recent excess supply of natural gas in North America can be largely attributed to discoveries of enormous gas pockets buried between various shale rock formations. New technologies, including hydraulic fracturing, have made such gas accessible. Unfortunately, there are some problematic consequences. Hydraulic fracturing (“fracing”) involves penetrating the shale formations through a process of high velocity injection of three to four million gallons of water (in combination with known dangerous pollutants, such as barium and strontium) to fracture the rock formations and increase the porosity of the formations and increase the gas flow. During the process, polluted water can contaminate underground water aquifers and the back flow of the water injection can contaminate surface water. Most current methods



of required remediation of the contaminated water involve high costs of disposing of the liquid in reservoirs or retention ponds, which can leach or cause further pollution. In April of this year, hundreds of

residents near Shreveport, Louisiana, were evacuated from their homes after a well being drilled nearby registered the presence of gas in the air and water.<sup>4</sup> Residents of New York and Pennsylvania, under which lies

the enormous Marcellus shale, are resisting fracing efforts. Authorities in the two states, as well as many other local governments, in which fracing is used are considering a ban on the activity or punitive taxes on the producers. This will become a global issue (Chart E).

Better remediation technology is on the horizon. Several private companies have developed mobile, onsite systems, which remove the pollutants from the contaminated water, applicable both in fracing and tar sands extraction. This not only alleviates the need to continually replace millions of gallons of water per well, but allows for a lower cost system which prevents contaminated water from leaching into other water supplies.

The process of energy generation consumes enormous amounts of water, primarily in the cooling and discharge process. Additionally, large amounts of energy are used in the process of water treatment and transmission. This symbiotic relationship will worsen over time. With rapid growth of energy production in industrializing nations, this problem will increase water scarcity in areas already threatened by water stress (see Chart A). For example, 20% of California's energy is used for transporting water from north to south, over mountainous areas. In Ontario, Canada, the amount is 30%. With China's plans to desalinate water in the south and transfer it to the arid north, a great deal of energy will be used. Local municipal water facilities in the U.S. must treat incoming water and remediate outgoing water, a process which consumes approximately 3% of the nation's energy.<sup>5</sup> We are investing in water storage and infrastructure projects, which will help alleviate the cost and generate power from the flow of water.

Electrical generating plants will have to recycle water, reduce water usage, and use sewage as feed water (or produce power from sewage). Xcel Energy, Inc. (XEL:U.S.), a large Midwestern utility, has installed low-water units that utilize air-cooled condensers, reducing the amount of

Chart E

Continent	Known Reserves	Probable Reserves			Total Reserves		
		(10e9 Barrels)					
Recovery (Gal/ton)	25-100	10-25	5-10	25-100	10-25	5-10	
Africa	100	Little	Little	4,000	80,000	450,000	
Asia	90	14	---	5,500	110,000	590,000	
Australia and N.Z.	Little	1	---	1,000	20,000	100,000	
Europe	70	6	---	1,400	26,000	140,000	
N. America	600	1,600	2,200	3,000	50,000	260,000	
S. America	50	750	---	2,000	40,000	210,000	
Total	910	2,400	2,200	17,000	325,000	1,750,000	

Source: Reserves and Distribution Data on Oil Shales, Jiang Han and Cui, 2007

water required for cooling.<sup>6</sup> Pinnacle West Capital Corp's (PNW:U.S.) Palo Verde nuclear reactor utilizes treated waste water in its cooling towers.<sup>7</sup> Without such efforts, large amounts of extremely hot and potentially toxic water can be discharged into waterways, endangering fish, wildlife, as well as water used by the public. Much of the world's energy (particularly in China) is generated by coal. In addition to the issue of carbon emission, many coal-fired power plants, during the cooling and discharge process, discharge pollutants such as mercury, which contaminates waterways, fish, and streambeds. Coal-fired power plants have been identified as the largest source of such mercury discharge, which can cause birth defects, learning disabilities, as well as nervous system damage, to people who eat contaminated fish.<sup>8</sup> Aside from conversion to gas-fired systems, which is not globally practical, the coal-fired industry is searching for better systems of recycling and remediation of water prior to discharge. We have invested in many private opportunities in this sector.

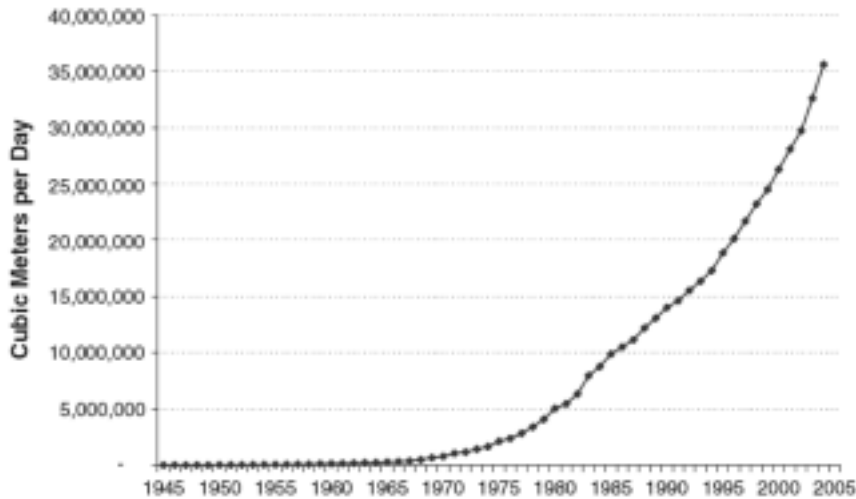
Desalination has increased rapidly in the last twenty years, as water starved regions turn to the sea (Chart F). It is expected that approximately 13,000 desalination plants will be constructed in the next fifteen years, in addition to over 15,000 existing facilities. Energy comprises approximately 70% of the cost of operating a desalination plant (Chart G). In the Persian Gulf, approximately 40% of the water supply is derived from desalination, a

figure which will increase as aquifers in the area are depleted. Renewable energy sources, such as solar power and wave wind (in use in Hawaiian and Australian plants), can help reduce some of the energy requirements.

Desalination (from the sea, brackish or waste water) essentially is accomplished by two distinct processes. In one process, water is heated to very high temperatures, removing the evaporated water, leaving the salt or debris. This process uses intense amounts of energy, which can be reduced by various new technologies. A vacuum can lower the boiling point, or a water spray can be exposed to high heat (flash desalination). In Hawaii, technology is applied that also produces energy during the process.

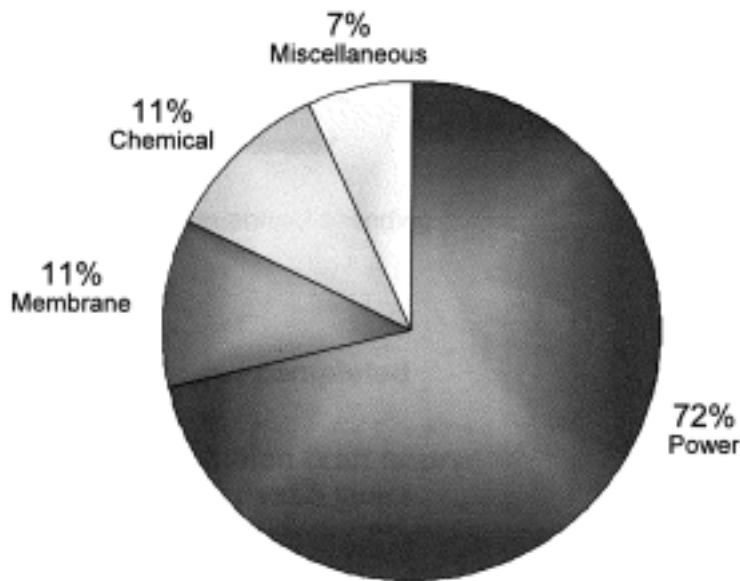
The alternative method of desalination involves the use of membranes and reverse osmosis, in which pressure forces water through membranes permeable by fresh water. This process is also very energy intensive. Various private and public companies, including Energy Recovery, Inc. (ERI:U.S.), in which we have invested, have devised better systems of membranes which reduce the energy required in the process. Even an energy savings of a small percentage, when measured against the long lives of these projects, amounts to a significant savings of money for the industry. With respect to the effects of the Gulf oil spill, it should be noted that oil-fouled water cannot be desalinated until the oil is removed. Thus, desalination plants should not be constructed near

Chart F **Cumulative Installed Desalination Capacity, 1945–2004**



Sources: Wangnick/GWI. 2005. 2004 *Worldwide desalting plants inventory*. Global Water Intelligence. Oxford, England; and the Pacific Institute

Chart G **Operating Cost of a Reverse Osmosis Desalination Plant**



Source: Bechtel 2010

water (about one-third of that from irrigation) to produce one liter of bio-fuel. This is roughly the same amount of water required to produce food for one person for one day.<sup>11</sup> The controversy will continue, with the future likely to depend on microclimates — in areas of Brazil and Eastern Europe, the amount of irrigated water required for bio-energy is negligible, while the water impact would be quite significant for very populous nations, such as India and China.

As our world increases in population, as well as in industrial and technological growth and energy usage, in the world of water, we have grown smaller. We are all consuming more of a finite and shrinking resource. Against the constraints of our limited water resources, we are continuing to attempt to introduce new means of energy production and industrial growth. The Gulf oil spill has reminded us of the limitations of even our most sophisticated technological efforts to harness energy resources under miles of water, while nature fights back. In this article, we have put forth just a few examples of the energy–water relationships and possible ways to reconcile our growing need to integrate our world’s development with our fragile global water system. As Lao Tzu reminded us twenty-six hundred years ago, we cannot resist it.

- 1 “Charting our Water Future” — 2030 Water Resources Group, 2009.
- 2 Ibid.
- 3 Aquatech International Corporation — “The Energy and Water Nexus”, Paris Global Water Summit.
- 4 WSJ.com, “Tainted Water Spurs Evacuations”, April 21, 2010.
- 5 Scientific American, “Energy versus Water: Solving Both Crises Together”, October, 2008.
- 6 NYTimes.com — “The Energy–Water Paradox”, October 24, 2008.
- 7 NYTimes.com — “Treated Wastewater for Thirsty Power Plants”, November 4, 2008.
- 8 Bloomberg.com — “Mercury Contaminates All Fish Tested in River Study, U.S. Says”, August 19, 2009.
- 9 Unesco — “World Water Development Report 2009”, chapter 7.
- 10 Ibid.
- 11 Ibid.

offshore drilling rigs until technology improves the process. We continue to look for opportunities in this growing field.

Controversy surrounds one area of energy production. Approximately 10% of global energy supply comes from “bio-energy”.<sup>9</sup> Biomass and biofuels are water intensive and compete with food production. Growth in water demand for food will continue to compete with water

demand for “bio-energy”. Produced from biological sources, such as grains, sugar crops, oil vegetations, cellulose (stalks, trees, and grasses), and organic waste, such liquid bio-energy is controversial because of its ability to also serve as a foodstock.<sup>10</sup> Much of this type of energy is used in developing nations. For example, 70% of Brazil’s cars can operate on sugar cane ethanol. Currently, it takes approximately 2,500 liters of

# THE GLOOM, BOOM & DOOM REPORT

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