

the Clarity April 2010 report

During the first quarter of 2010, stock and bond markets continued the climb started a year earlier. The broad stock and bond markets rose 5.9% and 1.8%, respectively. The smaller the company, the more it was in favor with investors; small caps rose 8.9%, mid caps gained 8.7% while large caps climbed just 5.7%. The past year has seen marked price appreciation across multiple asset classes – domestic stocks rose 52.4%, international stocks jumped 54.4%, high-yield bonds gained 56.2% and global real estate vaulted 85.1%. These numbers reflect an advance from the very depressed price levels of a year ago rather than anything resembling sustainable long-term rates of return. With stock valuations normalized, future return expectations should be moderated at today's price levels.

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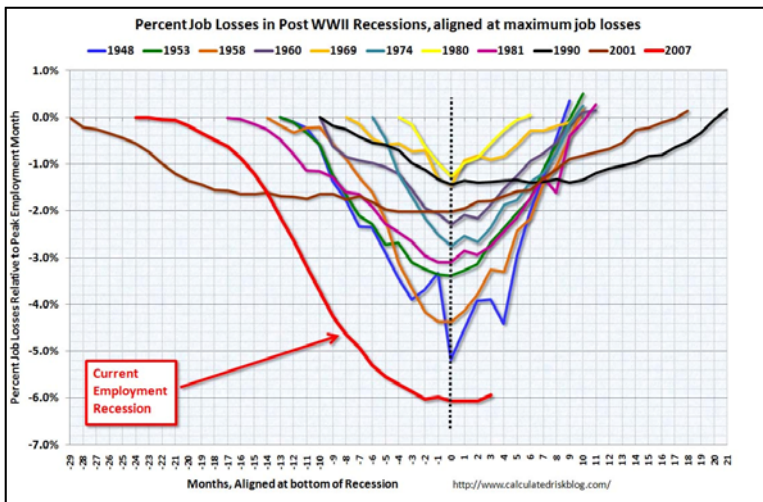
Skepticism about the economic recovery's durability appears to be fading, despite the massive government efforts that presently underpin it. The stock market has pushed still higher. The media would have us believe that the market collapse a year ago was just a flash in the pan. It may actually seem so now, since the economy appears to be back on track; those that didn't succumb to the emotion of the moment might now consider it a distant memory as their portfolio values may have rebounded from the crisis lows.

But while the economy is showing signs of improvement, it might be difficult to convince the 15 million unemployed persons, 44% of whom are considered long-term unemployed – out of work 27 weeks or more – that everything's coming up roses. Despite widely reported news of net job creation in March, the Bureau of Labor Statistics' (more robust) "household" employment survey showed the number of unemployed persons "little changed" during the month. And the percentage of total unemployed actually rose over the past couple months – from 16.5% in January to 16.9% in March – while the headline rate has remained flat at 9.7%. The chart below indicates the pace of recovery in jobs at present, relative to other post-war recessions.

clar'·i·ty: n. The quality or state of being clear.

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In the chart above, the vertical axis shows the percentage of job losses relative to peak employment prior to the recession, while the horizontal axis shows the duration in months. For comparison, each recessionary period is aligned to the dashed vertical line at the maximum job losses for that cycle. It's clear from the chart that in this cycle it has taken longer to reach the job loss nadir than in all other post-war recessions save 2001, and that job losses during this period have been more prolonged in duration, deeper in magnitude and are tracking to take longer to recover than in the past.

Still, there are reasons to be encouraged. Industrial production is picking up and real retail sales are on roughly the same trajectory as the average recovery of the past ten expansions. Job losses (though not real income) may have hit bottom. Temporary hiring, typically a leading indicator of future job creation, is showing gains for the first time in three years. (Businesses tend to hire temporary employees before full-time, as such workers do not require full benefits and can be utilized with more flexibility.) Stock prices have recovered to pre-Lehman Brothers levels and market volatility has been low. Business leaders are becoming more optimistic, which may portend an increase in the capital investments that drive sustainable economic expansion. On balance, consumers – who drive 70% of our economy – are deleveraging and getting financially healthier. Revolving credit fell at an annualized rate of over 13% during 2009 and aggregate consumer credit is down 6%. Savings rates remain above 3.0% of discretionary income, down from the recessionary peak of over 5.0% but well above the negative rates of 2005-2006.

NBER's (National Bureau of Economic Research) Business Cycle Dating Committee – the group responsible for dating official economic turning points – is not ready to call the end of the recession yet, however. During their recent meeting, the committee said, "Although most indicators have turned up, the committee decided that the determination of the trough date on the basis of current data would be premature. Many indicators are quite preliminary at this time and will be revised in coming months. The committee acts only on the basis of actual indicators and does not rely on forecasts in making its determination of the dates of peaks and troughs in economic activity."

Like the committee, we will not pretend to know what is coming next. To be effective, our investment philosophy does not rely on correctly predicting short-term economic movements. We're aware that the future is always uncertain and try to prepare for as many eventualities (both known and unknown) as possible in managing client investment portfolios. While we would welcome an economic recovery, we believe client portfolios are positioned well should one not materialize or should it prove less robust.

The Government and the Housing Market

A major component in the government's support for the housing market ceased at the end of the first quarter when the Federal Reserve (the "Fed") discontinued its mortgage securities purchase program. As we mentioned in last quarter's *Clarity Report*, the federal government (through the Treasury department), along with the Federal Reserve has been supporting the housing market in unprecedented fashion. In recent congressional testimony Tim Geithner, Secretary of the Treasury, indicated that the current level of support the government is providing to the housing market is unsustainable. We agree with this assessment.

First, the government – through its capital support of Fannie Mae and Freddie Mac (\$127 billion so far) and explicit backing of the Federal Housing Administration (FHA) – is guaranteeing the principal and interest payments to investors on nearly all of the mortgage loans issued over the last couple years. Second, they're providing cash for down payments to homebuyers in the form of refundable tax credits. Third, the Fed has been providing most of the capital the mortgage market needs to function by investing in mortgage securities.

Today's typical mortgage transactions have changed versus just a couple years ago. One of the biggest changes is that more efforts are being made to determine whether a borrower actually has the

“The government...is guaranteeing nearly all of the mortgage loans issued over the past couple years.”

ability to pay – to service the debt on the mortgage. A borrower seeking a loan must now verify income and assets – factors that determine the ability to pay – and is generally required to apply a down payment, albeit small in many cases, to a home purchase. If it didn't happen so recently, few would believe that these concepts are relatively new to the lending process.

What hasn't changed materially is the nature of the lending "supply chain"; once a loan is approved, the originator disburses the funds for the new mortgage to the borrower and then sells the note to entities such as Fannie, Freddie or FHA. When those entities purchase the loan from the originator, the originator receives cash that it may then use to originate still more loans. Where do Fannie, Freddie, and FHA continue to get the cash to buy these loans? Largely by packaging them into securities for sale to investors. And over the past 15 months, the investor at the end of the line has primarily been the Federal Reserve. For anyone who has refinanced a home or purchased a new one in the past year,

there is a good chance that Ben Bernanke and company are ultimately receiving the monthly principal and interest payments he or she remits to their mortgage service company.

Fannie, Freddie and FHA are more pervasive in home loans than even a couple years ago. In 2009, Fannie Mae bought and/or guaranteed approximately 39% of total single-family mortgage originations, along with Freddie Mac (26%) and FHA (30%), for a total of 95% of total originations (up from a total of 40% just a couple years ago). Each of these entities, as mentioned, enjoys essentially explicit support from the federal government and either holds the mortgages itself or packages them into securities for sale to investors. This hasn't been a very good business lately; Fannie and Freddie lost \$72 billion and \$22 billion, respectively, during 2009. (FHA lost over \$12 billion and ended the year with such a low capital ratio that its assets are now leveraged close to 200 times.) But despite losing such large sums, each company was able to grow loan purchase volumes, helped by the Treasury's combined capital infusion of roughly \$100 billion during the year (\$60 billion at Fannie, \$37 billion at Freddie). FHA is backstopped by explicit government support, though unlike Fannie and Freddie it has yet to seek taxpayer funds.†

These are not small numbers and it's clear that had Fannie and Freddie been left to fend for themselves in September of 2008 their guarantees would no longer have much value. They now enjoy explicit government support that does not look to end soon. Initially, the Treasury indicated it would support each company up to \$200 billion but on Christmas Eve 2009, the Treasury lifted its cap on support through 2012 - from \$400 billion in total to *unlimited*. Effectively, though, the Treasury cannot afford to let these entities fail and the support was never really limited in the first place. (Readers of Andrew Ross Sorkin's *Too Big to Fail* will learn just how arbitrarily the numbers for many of the government's interventions were determined.) Fannie and Freddie have always been quasi-government agencies and have essentially become arms of the government. If left unsupported, the market would force these businesses to shrink, as any available private capital would likely come at too high a price. Instead, with support they are growing.

The now-explicit government support of 95% of the mortgage market has given the Fed, which has historically owned default-free securities (mainly Treasuries), the confidence to buy \$1.25 trillion of mortgage securities. In order for the Fed to be buying mortgages (with newly created money) in such large amounts - amounting to over half of their balance sheet - they must ensure that they will see not only a return *on* their capital but also a return *of* that capital. And of course they are correct, courtesy of taxpayers.

We'll wrap this up by tracing the whole story from the perspective of a new homebuyer. A borrower finds a \$228,500 home and seeks a mortgage to provide financing. By applying for a tax credit, the federal government provides the 3.5% FHA-required

down payment, or \$8,000. When Fannie Mae buys the recently originated loan, the government's support has provided capital to the originating lender and, by extension, the homeowner. After Fannie packages a bunch of mortgages like it into a security, the Fed buys it, freeing up capital for Fannie to purchase still more mortgages from originators. And the cycle continues. Should the new homeowner - who has put in none of his own money - default on this mortgage (that the Fed now holds), taxpayer capital (through Treasury's investment in loss-making Fannie Mae) will make the security holder (Fed) whole on what is owed.†

As the dominant buyer in the market, the Fed has purchased mortgage securities for the past 15 months. According to the Wall Street Journal, the Fed acquired nearly the entire new supply of securitized mortgages over that time period. The active mortgage-buying program has had the effect of reducing interest rates for borrowers - from 6% before the program's inception to just over 5% now. But with their purchases having ended on March 31st, the private market will now have to take the place of the central bank in providing liquidity for mortgage financing. Time will tell whether private capital demands significantly higher interest rates and elevates costs for borrowers.

“Cash on the Sidelines”

Stock market commentators often like using the term “cash on the sidelines” to bolster their case. Because there is cash “just sitting there,” the argument goes, it must be poised to “flood into stocks” when investors “feel comfortable with risk” again. Because there is such a flood of cash moving into the markets prices must move higher! It is easy to accept this argument at face value because a single investor sees this at his individual level. An investor can look in his or her brokerage account and see stocks as well as cash “just sitting there” in money market funds “on the sidelines.” But this same truth does not hold for all investors as a group and funds shifted between money markets and stocks do not necessarily have the effect commonly cited in media reports. John Hussman, Ph.D, in whose fund we are invested, offers this illustration (emphasis ours):

“If Ricky sells his money market shares and buys stocks, then his money market fund has to sell commercial paper to Nicky, whose currency goes to Ricky, who uses it to pay for the stock bought from Mickey. In the end, the currency that Nicky held is now held by Mickey, the commercial paper held by Ricky is now held by Nicky, and the stock held by Mickey is now held by Ricky, and there is exactly as much stock, commercial paper, and currency outstanding as there was before. All that happened is that the owner of each security has changed.

“The price of any given security may or may not have changed as well. For example, if Ricky is very eager to buy stocks and Nicky and Mickey are happy with their existing positions, then Ricky probably has to sell his commercial paper to Nicky at a discount, and has to buy the stock from Mickey at a premium. What happens here is that Ricky has to sell more units of commercial paper for a given amount of cash, and more units of cash are required to buy a given amount of stock. So in this case, commercial paper

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prices fall (interest rates rise) and stock prices rise.

“In contrast, it might be that Mickey is eager to sell stock and Nicky is eager to buy commercial paper. This is good for Ricky. In that case, Ricky might sell his commercial paper to Nicky at a higher price, while buying Mickey’s stock at a discount. In that case, commercial paper prices rise (interest rates fall) and stock prices fall.

“In any case, *stock prices don’t change because money goes ‘into’ or ‘out of’ the market. Prices change because buyers are more eager than sellers, or vice versa.* If a dentist from Poughkeepsie is eager to buy a single share of General Electric (which has about 10 billion shares outstanding), and pays \$33.30 instead of \$33.20 for that single share, that one trade will increase the stock market’s capitalization by a *billion* dollars. *But at the end of the day, all securities that were originally in existence are still in existence, and there is just as much ‘cash on the sidelines’ as there was before.*

“At the aggregate level, ‘cash on the sidelines’ is a misnomer.”

“The upshot here is that investors should never look at ‘cash on the sidelines’ as an indicator of potential buying pressure. It just isn’t so. The cash is going to stay on the sidelines until the underlying debt securities are retired.”

For an individual, the cash he or she holds can be moved from money markets to stocks easily and it is not often clear who is on the other side of each transaction. But in the aggregate – that is, when viewed from the perspective of the investment community as a whole – the cash is not just “sitting on the sidelines.” At the aggregate level, “cash on the sidelines” is a misnomer. An individual selling his money market fund to buy stocks must find a willing buyer for his money market assets and a willing seller from whom to buy the stock. In aggregate, such securities simply change hands.

Revisiting Our Investment Process

With stock and bond markets exhibiting relatively benign behavior over the past several months – and most asset classes gaining in price – it can be easy to forget the role of asset allocation and mutual fund selection. Yet it is under such conditions where we become most skeptical; such advantageous conditions cannot persist indefinitely. Nassim Taleb, author of *The Black Swan* illustrates the perils of extrapolating today’s favorable conditions using what he calls the “turkey problem.” He offers the story of a turkey who is fed by a farmer daily. The feedings continue for 100 days, 500 days, 1,000 days; each day the feedings by this friendly farmer make the turkey more and more confident that tomorrow will be just like today...until a couple days before Thanksgiving. At the point where the turkey is likely to be the most certain that he’ll be fed again (just like yesterday), the 1,001st day looks very different from the previous 1,000...

We try to be turkey-problem-aware when establishing client asset

allocations and selecting mutual funds. During rising markets, it is often the riskiest assets that are “doing well” and we try to avoid them when valuations do not appear to offer adequate compensation for the risk. For instance, asset classes that have gained substantially – that is, are most likely to be overvalued and/or risky – also tend to be most prone to the turkey problem, i.e. have the most downside. This philosophy often keeps us away from emerging markets and commodities. It also leads us to generally avoid heavily indebted companies with little cash flow as well as those trading at optimistic valuations.

We like to highlight our process and revisit our investment philosophy with clients frequently, as well as present how we look at their present investment portfolios. We want clients at all times to have at least a basic understanding of how we’re managing money on their behalf, even if the specific implementation of that process changes from time to time. We would expect no less if our positions were reversed. As always, please contact us if you have any questions in this regard.

†Calculated by Clarity Asset Management, Inc.

The performance for the Russell 3000 Index is used as a proxy for the stock market, the Barclays Capital Aggregate Bond Index for the broad bond market. The Russell 2000, Midcap, and 1000 Indices are used as a proxy for small-, mid-, and large-cap stocks. The aforementioned indices are market-value-weighted. Membership in each index is selected based on a ranking of U.S. common stocks according to total market capitalization. Numbers do not reflect fees, brokerage commissions or other expenses of investing. International stock data reflects the net total returns of the MSCI EAFE Index in U.S. dollars. Global real estate reflects the performance of the FTSE EPRA/NAREIT Global Real Estate Index. High yield index performance sourced from Barclays Capital. Fannie Mae, Freddie Mac and Federal Housing Administration source data obtained from public financial filings, Treasury statements and from The Wall Street Journal.

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