STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS FEBRUARY, 2009

LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 1.572 * Dow Jones Industrials 8,599 * 30 year U.S. Treasury Bond 3.03%

CARPET BOMBING WITH CASH

What's the biggest problem the economy faces right now? We don't need any more houses or cars, and we're pretty well set for home furnishings and appliances, clothing, computers, and just about anything else you can think of. That sounds like great news—*we're all rich!!*—but it doesn't offer much hope for employment. In response the Federal Reserve is printing vast quantities of money, and flinging it out of airplanes and helicopters. They're carpet-bombing the nation with cash.

In 2010 we might find ourselves worrying about inflation, but that's next year's problem. Right now the Fed is just replacing the money that was destroyed in the mortgage panic and the subsequent de-leveraging of the economy.

"Leverage" is a fancy word for debt. Just as a lever allows you to multiply your strength when moving a rock, a hedge fund can multiply its common stock returns by borrowing huge amounts of money and investing three or four times as much in the markets. When banks borrow by taking deposits from the public they can then lend *ten times* their shareholder capital in a process that actually creates money and stimulates the economy. In recent years the famous investment-banking firms of Wall Street borrowed *thirty dollars* for every dollar of capital that had been invested by their shareholders. They put that money into mortgages and other securities, dimly aware that if the value of the mortgages declined just 3.33% that dollar of shareholder capital would be wiped out.

When these towers of debt collapsed, money was destroyed and lenders lost all desire to lend. The Fed is now putting money back into the economy, starting—as always—with the US Treasury bond market. For months the central bank has been buying Treasury bonds by the truckload, using freshly-printed $100 bills to push bond prices higher and bond yields lower. The prices of corporate and municipal bonds have already begun to rise in sympathy, starting with the highest-quality bonds and slowly rippling outward through medium-quality bonds and junk.

This time the Fed isn't waiting for the higher prices and lower yields to ripple outward through the markets. They're buying anything and everything, with a new focus on buying mortgages. Mortgage rates are already at 5%, and heading lower.

That's exactly what our economy needs. Millions of Americans have defaulted on their mortgages, causing massive losses for banks and other financial institutions. The banks (stuffed to the gills with mortgage paper) no longer trust themselves or anybody else, and they've stopped lending. Our economy can't function when the banking system is broken, and it doesn't help that a hundred million consumers—frightened to death by the

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> "Nothing on the left is left. And nothing on the right is right."
>
> -- Janet Yellen, President of the San Francisco Fed, on the balance sheets of banks, consumers, and other financial companies.

CARPET BOMBING... *continued from page 1*

media—are sitting on their hands in unison. It's a mirror image of all the media-fueled manias of the last ten years.

This is a problem of trust that started with a panic in the mortgage market, and that's where any credible and lasting solution should begin. The original plan for the Troubled Asset Relief Program (TARP) was to buy mortgages and keep buying them until their prices rose and confidence—trust—was restored. The Congress should have given the Treasury a blank check and a clear and simple directive to do just that.

Instead, Congress offered $350 billion—a small sum, when compared to the trillions of dollars invested in home mortgages—and said it would toss in another $350 billion if it liked what it saw. And the pledge was followed with scores of suggestions for paying off the mortgages of individual homeowners, bailing out companies located in particular congressional districts, and funding vast quantities of pork and lard said to "create jobs".

Hank Paulsen didn't trust the Congress to give him the funds he needed, so he changed the rules of the game. He began buying banks and insurance companies, because those purchases gave him a bigger bang for the buck.

The result was a whole new set of trust problems, like sewage flowing down a hill. Banks no longer knew what the rules of the game would be, and there wasn't any evidence that the mortgage market was going to get better soon. They took the money Paulsen gave them and stuffed it in their vaults, fearing that they'd need it in the months ahead. Corporations, unable to get loans from the banks, began laying off workers. Investors wondered whether the government would be able to borrow huge amounts of money without driving interest rates higher.

"I got out of tulips after the market collapsed, but I'm slowly getting back in. Especially pink ones."

Ben Bernanke rushed in to save the day, buying U.S. Treasury bonds by the truckload and then announcing that the Fed would execute the original TARP plan. If "Pat" Paulsen doesn't want to buy mortgages, Big Ben will print half a trillion dollars and do the job himself. Mortgage prices will go up, restoring to bankers a feeling of self worth and confidence, and mortgage rates will continue to go down. Businesses and consumers will be able to borrow again. And there is little reason to fear that interest rates will rise, at least not in the near term, because the Fed won't have to borrow any money at all. They're just going to print it.

In the long term we've got a huge mess to sort out. We came to this impasse because we borrowed too much, consumed too much, and printed too much money. It's not comforting to think that the way forward involves borrowing, spending, and printing billions of crisp new hundred-dollar bills. We can hope that Bernanke will stop printing money before he causes inflation, but we *know* that the Congress and the Treasury are going to do some lasting damage.

Paulsen has put the U.S. Treasury's official stamp of approval on the word "bailout", and there's a frenzied mob of congressmen clamoring for a piece of the action. They're already laying plans for a giant "stimulus package" of pork rinds and earmarks and pig tails. Bridges to nowhere! Bridges to somewhere! Museums commemorating anything and everything, and research programs to study the impact of flatulence on global warming! You'll start getting the bills a couple of years from now . . . .

LOOKING BACK AT RECENT ISSUES OF INSIGHT

Winter 2006: "The price of oil will probably dip below $30 in our next recession."

Spring 2006: "The air is coming out of the housing bubble."

Summer, 2007: "Cash still runs in rivers through the canyons of Wall Street. It's a frothing, foaming torrent, topped with glistening bubbles in commodities and foreign junk bonds . . . If it's risky *(the toxic waste from mortgage pools!)* investors are willing to pay a premium price. This is, after all, the Year of the Pig."

"Obviously, this is all going to come to a bad end. This is a bubble, driven by the notion that risky investments always produce the highest returns . . ."

"Yet some day the tide will go out. Confidence will evaporate, and that will be the end of that."

Autumn, 2007: "When interest rates are declining in a weak economy, you can't find a better haven than long-term U.S. Treasury bonds . . . . The prices of high-yield bonds have declined, but not much—and there is still great risk for investors here."

(Every issue of Insight published in the last six years can be found on our web site: www.Lumbard.com)

BUY CORPORATE BONDS

In September of 2007 we ran two short articles titled "Buy Treasuries" and "Sell Junk Bonds". Since then the 30-year Treasury bond has appreciated more than 30%, driving the yield as low as 2.6%. For the last three months we've been selling our treasury bonds at a robust profit, and buying the "medium-quality" bonds of telephone companies, railroads, and electric utilities at yields of 10% or more. We've also been buying the debt of government-supported (TARP) banks at yields exceeding 13% and prices that are just 60 or 70 percent of par value. We believe that many of these bonds will sell at 90 percent of par value a year from now, and in many cases that would represent a gain of 50%. Plus interest at the rate of 10% a year, or more.

The *stocks* of steady-Eddie, recession-resistant companies are also attractive, but there's a philosophical case for shifting towards bonds. Congress no longer sees corporate profits as an important engine of economic growth, and in fact those profits are mostly seen as a source of tax revenue. Harry Reid and Nancy Pelosi will fight like hell to keep failing corporations alive, but the goal is to preserve existing jobs. Shareholders, entrepreneurs, and rising stock prices are yesterday's news, along with the notion that our economy grows (and spreads wealth) via a dynamic process of creative destruction---with Microsofts and Intels rising to take the place of steel and stumbling automobile companies. The status quo is IN. Big success stories are OUT.

This environment clearly favors bond holders, who continue to collect their interest checks as long as their companies stay alive. Bond holders won't have to worry about increased regulation, high corporate taxes, or static corporate profits; especially when the federal government stands ready to bail out anybody and everybody. And if a company does find itself in receivership, shareholders have little claim on anything. Bond holders might get back 2/3 of their investment or more.

We see no reason to place bets on the timing of economic recovery, here or in other nations. We're also not betting on the dollar, commodities, interest rates, or much of anything other than the likelihood that the stocks and bonds of solid companies will recover from unreasonably-low levels as the Fed fills the economy with cash. At some point we'll begin to worry about inflation, but not this year. The tide is rising, the sun is shining, and the interest checks are rolling in.

John Lumbard, CFA

The European experience shows that gasoline taxes are effective in improving the gas mileage of automobiles and reducing the number of miles that they are driven. Gasoline taxes work, and the proceeds can be rebated to the taxpayers.

Europe's "cap and trade" carbon permits, on the other hand, have been a failure—doing little to reduce carbon emissions while harming her economies with a huge burden of complexity and red tape. They call it a "market", but government controls the supply of permits, and government controls the demand for permits. Government therefore controls the cost of permits, so why not cut through all the deliberate dishonesty and simply levy a tax?

"You want a deal real bad? Here's a real bad deal."

-- The CEO of a small public company, explaining how hard it can be to raise capital during hard times.

QUADRUPLED, EVEN NOW

On December 31, 2008, our "benchmark" account---the one that started in October of 1990 with $100,000---stood at $446,064, down just 3.3% over the course of the year. Over the last ten years the account, all fees and expenses included, appreciated from $241,129 to $446,064 while the S&P 500 index declined from 1,265 to 903. To be fair you should add to the S&P number its dividends, which averaged about 1.6% per year.

In 2008 the S&P 500 dropped 38.5%. Famous investors who had outperformed the markets for decades---Ken Heebner, Bill Miller, Dan Rice---saw their portfolios shrink by 50% or more. How did we avoid the carnage? We saw the bubbles in the real estate, subprime mortgage, oil, and commodities markets, and wrote about them in this letter. We had big holdings of U.S. Treasury bonds, which appreciated handsomely as interest rates declined. We held shares of a new fund that bets against oil prices, and oil prices fell. Most of all we expected a recession, and invested only in stocks and bonds that should hold up well in a shrinking economy.

If you had a bad experience in the past year, please visit our web site (www.Lumbard.com) to learn more about our performance, fees, minimums, and other details. Then give us a call, at (800) Lumbard, which works out to 800-586-2273.

Laura Miller, on the recent appearance of vampires—in the role of handsome leading man—in romance novels:

"The source of vampire wealth is obscure, since few of them appear to be gainfully employed. The assumption seems to be that anyone who's been around for 300 years must be in a position to take full advantage of the miracle of compound interest."

The IRS has increased the gift tax exclusion to $13,000 per year, per recipient. You now can gift up to $13,000 each year to a child (or anyone else) without any tax consequence.

American corporate taxes are some of the highest in the developed world. A year ago Exxon reported earnings of $40 billion for its shareholders, and paid taxes (federal, state, and local) of $30 billion.

To: The First National Bank of Uncertain Returns

From: A Depositor

Dear Sirs,

In view of current developments in the banking market, if one of my checks is returned marked 'insufficient funds', does that refer to me or to you?

THE DEBT BOMB

The problems of Social Security are a walk in the park in comparison with the bankruptcy of Medicare. The Congressional Budget Office projects that Medicare will cost $492 billion—almost half a trillion dollars—in 2009. The Medicare tax (a portion of FICA) will cover only about $72 billion of that, leaving a shortfall of $419 billion.

That $492 billion works out to $4,473 for each of the nation's 110 million households---and that's just for 2009. Eight years from now Medicare is projected to cost $850 billion a year, or $7,025 per household. Per year. The TARP program is chump change by comparison, and the same can be said about the Iraq war and even the trillion-dollar stimulus package. An annual expenditure of $500 billion is *25 times* as large as a one-time expenditure of $500 billion . . . .

And Medicare is growing rapidly. It will soon grow past the defense budget, just as Social Security grew past defense in the mid 1990s. In 1962, when John F. Kennedy was president, Medicare had not yet been invented, and Social Security was less than 14% of the federal budget. Defense spending was 54%.

The future cost of Medicare, Social Security, and other "mandatory" expenses can be expressed in terms of a lump-sum figure that each American household owes today. The Concord Coalition pegs that figure---the amount that you will pay in today's dollars---at $455,000.

THE MADNESS OF MADOFF

Bernie Madoff accepted money only from people he liked and respected. At some point (after 29 years or so), guilt must have overtaken him, because un-cashed checks totaling *$173 million* were found sitting in his desk. Confidence in Wall Street and in the SEC has been shaken, and with good reason.

The truth is that it would have been hard for most investors to spot the fraud. Some have said that Madoff's clients should have been tipped off by the fact that their accounts never had a bad year, but their best hope was to recognize that Madoff himself was holding their funds. Of course, the funds were held in a separate, Madoff-owned but SEC-regulated brokerage firm, so it wasn't really much different from putting your money in a Fidelity brokerage account, and then investing it in Fidelity funds.

Our client accounts are held in the names of our clients by a true third-party custodian, U.S. Bank. That third-party custody costs our firm a lot of money, but it's an important protection for our clients, and it's also a factor in the performance of their accounts. Our recent purchases of corporate bonds (spectacular purchases, at 13% yields and prices as low as 58% of par value) would not have been possible if our accounts were held with a brokerage firm. And there can be other constraints to brokerage custody that crop up in foreign investing and other arenas.

Drew D. Kellner

You can look up our firm on the SEC web site at http://www.adviserinfo.sec.gov. Our U.S. Bank representatives are Denise Fultz (513-632-4256) and Terry Schwartz (513-632-4992); feel free to call them to ask whether our clients have assets there, and whether those assets have been growing. We don't want to alarm you, but our average account didn't decline when the tech stocks crashed, and only slipped a couple of percentage points in 2008 . . . .

For years Saudi Arabia has been asserting that they have enormous reserves of oil, and plenty of spare production capacity. Matthew Simmons accused them of lying, and for some reason (could it be greed?) investors believed him. It took a few years for the drama to play out, but the Saudis are now in the process of opening *four* giant new oil fields. Simmons should clear some space in his yard, in anticipation of a sizable delivery . . . . .

BORROWING AND SPENDING

While the Fed prints money like mad, the Congress is cooking up a plan to spend a *trillion* dollars—a million millions—of *borrowed* money. It's a much larger version of the spending push that the Congress undertakes after every recession, nearly always spending too much and too slowly. The money wends its way through parliamentary procedure, bureaucracy, and red tape, and finally goes to work—often in all the wrong places—long after the economy has started to recover on its own.

The most recent episode started in 2001, after the stock market crashed and the World Trade Center was destroyed. At the time our legislators were terrified that we were about to slide into a 12 - year recession, because that's what happened in Japan after that nation's giant stock-market bubble burst. The Fed printed money to drive interest rates down, and kept printing money as the Congress started spending on stimulus packages and pork. The unemployment rate dropped to one of the lowest levels of the last 40 years, and the Congress kept spending on stimulus packages and pork.

Here we are again, trying to blast our way out of another scary-looking recession. For decades we've been juicing up economic growth by borrowing and spending at the government, state, municipal, corporate, and personal levels. Every time a recession gets under way our congressmen borrow and spend some more, and then congratulate themselves for *Bold Action in Saving the Economy.*

Recessions are natural events in a free market. They clean out debt, punish those who take foolish risks, and force businessmen to set aside greed, hope, and other emotions when making important decisions. With the help of *bold congressional action* we nevertheless accumulate debt as the decades pass, reaching for higher highs of risk and confidence and poor judgment, until—every three generations or so—we experience a bigger event that really whups people upside the head. It would appear that frugality and debt aversion can be passed from father to son, but not from grandfather to grandson.

We managed to escape that whupping in 2002, but we paid a price in increased consumer, homeowner, and government debt; overconfidence on Wall Street and everywhere else; and soaring inflation in the real-estate market that resulted from years of Alan Greenspan's easy money policies.

It would be a bad idea—a very bad idea—to try to do that again. The simple truth is that there's no way to transition from over-consumption and borrowing to a normal, healthy savings rate without a lot of pain. We *need* this recession, and the government should let it play out in a more-or-less normal fashion without nationalizing the banking system, the insurance industry, or Detroit.

Japan kept half-dead banks and corporations on life support for years, and paid a heavy price. There is a great danger that *bold congressional action* will shift investment capital and resources away from productive areas of the economy, reward bad decision-making, and remove the incentive to work.

What, then, do we need to bring an end to this recession? Time. Let the Fed do its work, and then let the economy heal itself. Real estate prices will fall until buyers can't help but buy; bankruptcy will weed out weak and incompetently-managed banks and corporations; and consumers will learn to save for the future. Each of us will begin to make the hard choices that strengthen balance sheets, allocate resources, and reduce the debt that almost wrecked our financial system. We can take our medicine now, or face another crisis in a few years. Why would anyone want to go through this again?

John Lumbard, CFA

The Grass Is Not Always Greener

Life on the other side of the fence.

The USSR was a grand experiment in big government. It failed because mere humans were simply incapable of replicating the incentives and disincentives that free markets provide. When communist planners tried to reward chandelier manufacturers for increased output, as measured in pounds or kilos, the weight of chandeliers grew until ceilings began collapsing all over Moscow. When they rewarded glassmakers for increasing the square footage of window glass produced, windows began breaking as they left the factory. “We pretend to work and they pretend to pay us” became the motto of the working man, and the Soviet Union collapsed in a haze of alcohol and finger pointing.

In the 1980s Americans gazed longingly at the success Germany and Japan had experienced in guiding their economies toward favored industries and rising employment. Japan fell out of favor just a few years later, when it became obvious that its elite legislators and bureaucrats were employing government programs, earmarks, entitlements, and bailouts to prolong a 12-year recession. That failure left Germany as the guiding light of socialism, and it remains a beacon to this day.

Yet the truth is that Germany’s unemployment rate hasn’t dipped below 8% in fifteen years, and in that time it’s been as high as 12.7%. Even now, a year into a tough recession, our unemployment rate is a full percentage point below the best that Germany has produced. And the German population is hard-working, well-educated, and homogeneous. If we were to graft the entire German system onto our own, is there any chance that our Congress would be able to keep our unemployment rate under 15%?

Our Congress can’t even manage its primary responsibility, the federal budget, and it’s made a mess of the nation’s health care system, our housing and mortgage markets, energy policy, unfunded mandates, our ridiculous tax code, and just about everything else it touches. A larger government would mean more power to the Congress, and more money passing through congressional hands.

Economies are successful when good decisions are rewarded and bad decisions are punished

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In the long term government is just an expense borne by our economy, in the way that a horse carries its rider. The rider can’t carry the horse, and the bigger he gets the less progress he’ll make. Government programs can stimulate parts of the economy in the short term, but they always suck resources from other parts of the economy. And they create disincentives to hiring, expansion, and entrepreneurial activity that few legislators can grasp.

Recently a young woman expressed to us the opinion that “we need to start over, with a whole new [economic] system.” This sentiment is not uncommon, in the aftermath of the mortgage

meltdown and the horrifying bailouts announced in the papers every day. Americans need to understand that these bailouts are not consistent with the free-market philosophy that has guided the American economy since the 17th century, and they need to understand that you can't walk away from our existing system without walking toward an alternative.

All the available alternatives are less attractive, because the alternatives do such a poor job of providing the incentives and disincentives that create jobs, drive innovation, and persuade people to put forth their best efforts every day. Economies are successful when good decisions are rewarded and bad decisions are punished, and that principle is rarely applied with any consistency when economic activity is guided with a heavy hand. Governments—particularly democracies—are reluctant to allow failing companies to fail, and they're reluctant to allow the market to punish bad decisions, laziness, and greed.

Ours is a Tough Love economic system, and when we try to make it more compassionate we take away its ability to generate new jobs, new ideas, and new wealth that—contrary to the assertions of the press—reach all the way to lowest rungs of society. Have any of these reporters stopped to think about the living conditions of the poor in the 1700s, the 1800s, or even the 1970s?

"If we can but prevent the government from wasting the labours of the people, under the pretence of taking care of them, they must become happy." -- Thomas Jefferson

John Lumbard, CFA

Performance Results:

The performance results presented below are for our "Benchmark Account", using January 1, 1998 as the date of inception. The performance results for the Benchmark Account are calculated by Lumbard & Kellner, LLC's current custodian, U.S. Bank (prior to 2004 State Street was the custodian). The account pays fees based on our firm's fee schedule from the 1990s (top rate of 1%), and the percentages shown are net of fees and expenses—that is, the returns shown would have been higher if fees had not been deducted. The performance results for the Benchmark Account include the reinvestment of dividends and other earnings, but there have not been any other additions or withdrawals since inception. The comparative indexes shown are the S&P 500 Composite Index, Dow Jones Industrial Average, NASDAQ Composite, Barclays U.S. Aggregate Bond Index, and the Citigroup 3 Mo T-Bill Index.

Actual returns for individual client portfolios managed by Lumbard & Kellner, LLC may vary and will not necessarily coincide exactly with the returns for the "Benchmark Account." Past performance of the "Benchmark Account" does not guarantee future results. No assurances or guarantees can be given or implied concerning future investment results for Lumbard & Kellner, LLC or any investment index. Future returns may differ significantly from the past due to materially different economic and market conditions and other factors. Investments within portfolios, and therefore, portfolios, involve risk and the possibility of loss, including a permanent loss of principal.

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