

LUMBARDE
INVESTMENT
COUNSELING

INSIGHT

Nasdaq Composite 2,236 * Dow Jones Industrials 10,415 * 30 year U.S. Treasury Bond 3.85%

HOW 'BOUT A LITTLE OPTIMISM?

"We're in a long period of readjustment---a needed readjustment---and there's no point in trying to force an unnatural growth on consumers or anybody else." -- Insight, Autumn, 2009

A Double Dip? Just three months ago every pundit in America was putting out urgent warnings about inflation, and now they're wailing about **DDDeflation**. Please! Since World War II the only double-dip recession we've experienced was engineered by the Federal Reserve.

No, the real bugaboo is a long period of stagnation, and that's been clear for a long, long time. For more than a decade we've been following Japan's boom-and-bust script, which started when her twin bubbles—in real estate and in the stock market—burst in the late 1980s. Over the course of the next 13 years Japan's GDP grew at just 1% a year, and her government accumulated the world's second-largest debt (as a % of GDP)—after Zimbabwe. They used the money to suck skilled workers, entrepreneurs, and capital from the real economy to government programs, and

eventually reached the point at which it became difficult to feed and clothe and house all the newly-hired bureaucrats . . .

That "Lost Decade" was still under way when our own stock-market bubble burst in 2000, so Washington went into a panic. If the World Trade Center hadn't collapsed in a ball of fire they might have been able to see the irony of trying to avoid an American Lost Decade by employing the very same strategies that Japan had tried. They couldn't, of course (there's a reason why you never see the phrase, "**Congress, in its wisdom**"), and went on a spending binge—bridges to nowhere!—that was quickly matched by aggressive action at the Federal Reserve. Hand in hand they inflated a bubble in our own real estate market, and when it burst they stimulated some more. Lots more.

Happily, we're NOT going to do any more stimulus spending, because most Americans have witnessed first-hand what happens when those programs come to an end. August car sales were down 21% from the *CashForClunkers*-swollen numbers of August 2009, and the

end of other stimulus programs is causing unemployment claims to rise.

There's still plenty to worry about, because we owe a lot of money to foreigners. Japan was able to borrow all the money she needed from her frugal, wealthy citizens. Yet, strange as it seems, Grasshopper, our meager savings might be a good thing---because they give our central bank more power to stimulate our economy. In the United States low interest rates spread wealth by allowing us to refinance our mortgages at low rates, while in Japan low interest rates rob savers by slashing the interest rates they receive on their bank accounts. This year millions of Americans will trade in their 6% or 7% mortgages for 4.5% mortgages, giving them *thousands* of additional dollars to spend each year.

They'll save hundreds more as a result of new technology that created a glut of natural gas from coast to coast. Hundreds of thousands of homes will convert from heating oil to clean gas, and fortunes will be made by those who can figure out a

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A LITTLE OPTIMISM... *continued from page 1*

better process for turning gas into gasoline or diesel fuel. In many parts of the world gas has so little value that drillers burn it at the well head, and take only the oil to market.

Another great technological leap is happening in deepwater oil drilling. Most Americans are trying to forget those images of an unstoppable geyser of oil in the Gulf, but they'll be shocked and thrilled to learn of the voracious appetite of the micro-organisms that have been devouring oil—50 million gallons a year—in those waters for centuries. And investors should *try* to remember those images, because there was *an unstoppable geyser of oil* just a few miles off our shores. Next year you'll see tens of thousands of jobs created as we employ safe and surprisingly cost-effective techniques—a gusher of new oilfield technology—to tap deep wells all over the world.

Japan's bubbles were larger than ours, so her economy had a larger adjustment to make to return to a normal GDP. And this process

occurred at a time when South Korea and China were imitating Japan's mighty export model and eating her lunch. Korea and China have *already* hollowed out *our* manufacturing industries, and it's not going to get any worse from here. Really.

Capital spending is already picking up, at least in equipment, software, and the kind of big machines that Caterpillar makes. Corporate America as a whole is in terrific financial shape, and has trillions of dollars to spend. And employment is up: if you adjust for the census, August was the eighth month of gains.

You might not feel wealthy enough to re-do the kitchen in 2011, but frenzied consumerism wasn't as satisfying as many people once expected. This is a year to focus on health and leisure, and spend more time with the people who matter in your life. So untie that hangman's noose, step away from the window ledge, and go buy yourself a Double-Dip ice cream cone. Made right here in the U.S. of A. ■



"We know stocks are going up but we don't know which ones or when."

MEDTRONIC

"Hi! I have had a Medtronic pump for 4 months now and I LOVE it! Mine cost about \$6000, but insurance covered about \$5000. I'm not sure of the cost of supplies because my mom orders them, not me. It is really easy to use and will definitely help control your blood sugar It doesn't bother me at all when I do sports (but it made a hole in a brand new leotard). It is a lot more convenient. I used to have to do shots at rodeos and it was a pain. Hope it works out if you get it!"

-- A tweenage girl, writing in an online forum about her Medtronic continuous blood-sugar monitor and insulin pump.

Health-care-policy wonks should note that the girl's family paid 20% of the cost of the insulin pump, so it was a carefully-considered decision; they had *skin in the game*. Investors should notice that the price of a share of Medtronic stock (MDT - \$32) has been cut in half in the last 4 years, while earnings have grown 50%. At these prices even the modest dividend looks big: Medtronic shares pay 2.9%, which is *more than twice the yield on a five-year U.S. Treasury bond*. ■

"We are obliged to announce that some people in this country have been drawing pensions, although they may have died years ago."

-- Deputy Labor Minister George Koutroumanis of Greece

GOOD NEWS

Every time you turn on the television these days you hear expressions of fear, about the stock market and the economy. People know that housing isn't going to drive the economy forward in this recovery, the way it usually does, and they won't be able to relax until they know what will take its place.

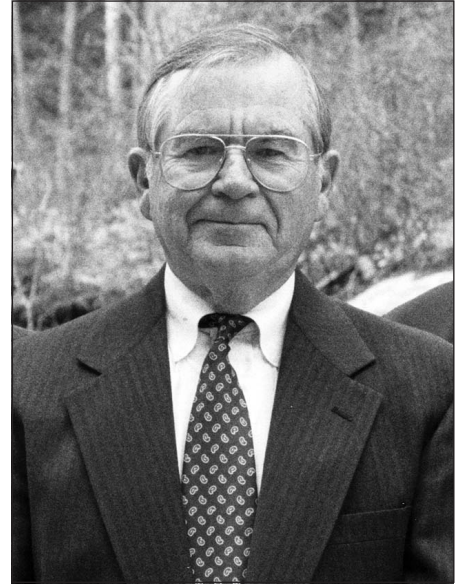
What they need to understand is that our economy *wants* to grow. And it will grow, on its own and in mysterious ways, unless something stops it. Often it's the Federal Reserve that stops the economy, raising interest rates and cutting off credit because inflation has reached unacceptable levels. In 2007 and 2008 loans and mortgages were cut off despite the best efforts of the Fed, because Fannie Mae, Freddie Mac, and the banking system were in crisis. Today there is still too little credit getting to small business, but once this problem is solved we won't have any barriers standing in the way of growth.

There is also less credit available

to consumers. This means lower spending, but the foundation of the economy is much sounder as it is not based on excessive debt. The economy will grow, but at a rate that will not satisfy either the public or the politicians.

Where will the growth come from? Corporate America has almost \$2 trillion in cash to spend, and companies have been refinancing their debt at such low interest rates that they are saving huge amounts of money. These companies are feeling cautious because of the anti-business sentiment in Washington DC, but many are replacing worn-out equipment, upgrading to new technology, and seizing new opportunities in oil and gas drilling and other industries. And automobile sales will be higher in 2011, because we've been destroying them faster than we've been building them since the recession started nearly three years ago.

Bull markets climb a wall of worry, and you don't often see the level



John Convery Jr., CFA

of worry that was on display in August. John Templeton said that you should "buy at the point of maximum pessimism." A lot of words have been written about the ten-year decline of the stock market, but this is absolutely the wrong time to draw new conclusions about long term investing. Keep in mind that these are the same prophets who told you, when stocks were hitting their highs, that equity investors can expect reliable returns of 10% a year. ■

MORE GOOD NEWS

Crime is down. Violent crime declined 5.5% in 2009, nationwide.

Highway deaths are down. In 2009 they fell below 34,000; the lowest death toll since the government began keeping records in 1954.

Divorce rates are down, to the lowest level since 1970.

Survival Rates Are Up for cancer, AIDS, heart disease, hypertension, and diabetes.

It's Heaven On Earth: Forget computers and airplanes; what a visitor from 1776 would envy most would be our spectacular, year 'round, fruits and veggies. ■

"Investors withdrew a staggering \$33.12 billion from domestic stock market mutual funds in the first seven months of this year."

-- The New York Times

During the housing bubble a lot of Americans believed that you could become rich by living in a mansion. In all the rest of recorded history Americans had believed that you had to *be* rich to *afford* living in a mansion.

MAGIC!

We can't emphasize enough the magic that occurs when a company buys back shares at a ridiculously-low price. If a company sells at ten times earnings—that is, the stock sells for \$10 and the earnings are \$1—those earnings are 10% of the price of the stock. The company can pay a 10% dividend, or use all those earnings to buy back 10% of the company's shares. If it starts the year with a million shares, it will end the year with just 900,000.

900,000 is a lot smaller than 1,000,000. Even if the company has ZERO growth next year, it's still going to divide its profits among a much smaller number of shares. If you do the math you discover that the earnings jump from \$1 per share to \$1.11 per share. Management has turned zero growth into growth of *eleven percent!!*

This is really happening, all across blue-chip-stock land. IBM, Raytheon, and Microsoft have been



buying shares. Lockheed, which sells at just about ten times earnings, just bumped up its earnings forecast by 20 cents because it's been buying shares at lower-than-expected prices.

In 1999 Microsoft earned 70 cents per share, and paid no dividend whatsoever. The stock reached \$59.56. Eleven years later the stock is down to \$24—no, there weren't any splits—and earnings per share are up to \$2.40. Microsoft is raking in huge amounts of cash that can be used to pay the 2.3% dividend, *and* buy back huge numbers of cheap shares. The result will be a

near-guaranteed boost to the growth of those earnings per share.

Eventually investors are going to notice that scores of companies are turbocharging their earnings growth in this surefire way that doesn't depend on the economy, industry growth, or brilliant new products. Was Microsoft a good stock to buy in 1999, when everybody loved it and the economy was strong? No. It was a truly awful investment. Is it a good stock to buy now, when nobody gives a damn and the economy is weak? *Follow the lead of the world's biggest and best corporations. Sell their bonds, and buy their stocks.* ■

BREAKING NEWS :

The government says it hasn't been able to spend all the stimulus money because of an urgent shortage of bureaucrats.

A balanced-budget amendment to the Constitution would assuage the fears of our foreign creditors (so we won't have to pay a *trillion* dollars a year in interest, at a 10% rate), while giving Congress a few years to reduce its deficits without killing the economic recovery. Join the ABBA: <http://www.balanceourbudget.com/>. It's free—but please donate \$10, get a bumper sticker, and put it on your car!

THE REST OF THE STORY

There's never enough room for all the articles we write for Insight. One of the articles that didn't make the final cut—a piece on the "Safe Withdrawal Rate" (the amount of money that you can safely withdraw from your investment portfolio)—can be found at [WeElectedYou.org](http://weelectedyou.org) (<http://weelectedyou.org>, August 1).

You'll also want to read Jim Schaefer's piece on the Big Lie that is the Social Security trust fund (The Debt Government Owes Itself for Raiding Social Security, August 18), and Mike Smith's Tales From the North Atlantic, June 14. Finish up by clicking on "Funny Bits" (in the blue bar near the top of the screen) to watch a pair of Saturday Night Live and Clark and Dawes videos.

CONGRATULATIONS

In August Drew Kellner passed the third and final level of the feared CFA exams. Only 46% of the candidates passed this level, and just 20% made it all the way through. And we're not talking about an average sample of college graduates; the nation's best and brightest have been dashing themselves against these rocks for many years.

In fact, hopes are regularly dashed all over the world. This year thousands of candidates sat for exams in London, Tokyo, Singapore, Geneva, Amsterdam, and Frankfurt, and there were many thousands more in locations as far flung as Kathmandu, Jakarta, Sao Paulo, and Hanoi. ■

20 YEARS IN BUSINESS

At the Same Location in Beautiful Downtown Hollis, NH

We opened our doors in 1990 with exactly *nothing* under management, and it was a slow slog from there. One of our first accounts was the one we track on a regular basis; it climbed rather slowly from a value of \$100,000 in October of 1990 to \$575,469 on Sept. 9. In the intervening years our account minimum grew to \$1 million, and our assets under management have reached \$85 million.

You can find the performance of our larger accounts, gross of fees, on our web site (www.Lumbard.com). The numbers are compiled by our custodian U.S. Bank, which is arguably one of the two strongest banks in the nation. Terry Schwartz, our relationship manager at the bank, can be reached at (513) 632-4992. And please call us for additional information—don't forget to ask for a Form ADV Part II (!!)—at (800) Lumbard / (800-586-2273). ■

A TALE OF TWO STATES

California's top income tax rate is 10.3%, and single filers pay a rate of 8% on income above \$38,000. Sales taxes range from 8.25% to 10.75%, depending on the local jurisdiction. California is nevertheless staggering under the weight of gigantic budget deficits and unfunded liabilities. The unemployment rate in California is 12.3%.

Here in New Hampshire the unemployment rate is 5.8%. We have budget pressures, but they are manageable. Our state is ranked each year as one of the least corrupt

in the nation. Our state legislators earn just \$400 a year. We have no sales or income tax.

You'd think that California's legislators would try to learn from other state governments, but they're blinded by pride and prejudice. And the same is true in Washington. Xenophobia rules in our nation's Capitol, which could derive great benefit from a simple review of the tax, regulatory, and health care policies of successful countries in various parts of the world. ■



Drew D. Kellner, CFA

Three cheers for an SEC ruling that will allow shareholders to nominate candidates for "their" board of directors. For the first time they'll be able to choose between the CEO's skill and some other candidate. Two candidates are always better than one.

"Economist Gary Shilling concluded last year that 52.6 percent of the nation now receives significant income from government programs, up from 49.4 percent in 2000 and 28.3 percent in 1950. . . . What's happening here is that the segment of the population that has a financial interest in containing the growth of government is dwindling, while the one that sees politicians as an income source grows. Under those circumstances, it's virtually impossible to sell fiscal discipline as an agenda."

--Jim Wooten,
The Atlanta Journal-Constitution

HOW TO HELP THE ECONOMY (Without Hurting It)



As you look around at the well-educated and hard-working people of other nations—living in cities with 50-story buildings and sophisticated infrastructure—you have to wonder how we've been able to claim such a large percentage of the world's wealth. A pessimist might note that we borrowed our way to a bigger life style, but you also have to mention the ease of launching businesses, our longstanding focus on creating and protecting new technologies, and the ease of finding consumers (in our giant market) to buy products and services.

America continues to be an attractive destination for the world's best and brightest emigrants, when we aren't barring their entry in favor of the worst and dimmest. These new citizens are responsible for launching fully a quarter of all our new high-tech and engineering firms.

Still, the answer that matters most is in our heads. Americans believe that an entrepreneur with a good idea and a strong work ethic will become wealthy, and they're OK with that. In fact, they believe that they can make lots of money themselves by investing in his venture.

The unique result is that bold visionaries with little in the way of experience or a track record can

raise money, launch new industries, and create jobs. It's a good thing that they do, because The Economist relates that "Even in boom times, 15% of American jobs disappear each year. Their places are taken by new ones created by startups and expansions."

Our economy is a dynamic beast; in July 4.2 million people were hired, and a similar number were laid off, quit, or retired. *Preventing* job losses, as in the GM bailout, isn't going to keep the unemployment rate from rising. We need new jobs, and lots of them.

Most of the activities of government push up the unemployment rate, but there *are* a few things that Washington can do. Right now the U.S. has a glut of workers in the home building industries, and a *shortage* of machinists and other highly-skilled manufacturing workers. Our retraining programs need to do a better job.

And we need to allow Intel, Microsoft, and other disgruntled technology companies to bring in top foreign engineers and scientists. It's reasonable to assume that we can create jobs for *several* unemployed Americans by bringing in a single highly-skilled and inventive immigrant.

Bill Gross has called for a program that would allow every homeowner, not just those with good credit, to re-finance his mortgage at today's

low rates. The Economist adds that we need to find a way to help unemployed workers move out of places like Detroit, where home values have dropped so much that nearly everybody has negative equity in his home.

The same applies to small business. Most entrepreneurs are perpetually saddled with debt—they *need* big incomes to pay off their loans—and right now a million shop owners, inventors, and small-scale manufacturers are staggering under the additional weight of debts that they rolled up during the recession. They couldn't get bank loans during the crisis, so they started borrowing on their credit cards at usurious interest rates. Now their credit ratings are ruined.

They could use some help from Washington, and what they're hearing instead is that the cost of hiring and keeping employees will rise. Red tape and regulation are rising, and higher taxes will mean that they never ever pay off those debts If our entrepreneurs, scientists, visionaries, and investors come to believe that our government will take away most of the profits from a new venture, they might not try. That pot of gold at the end of the rainbow is the lure that creates jobs and drives our standard of living higher. It's also the key to the powerful belief that this is a land of opportunity.

— 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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