WEDGE WATCH Q1

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The Road to Perdition?

"The whole history of civilization is strewn with creeds and institutions which were invaluable at first, and deadly afterwards."
–Walter Bagehot, British businessman, essayist and journalist (1826-1877)

First Quarter 2010
Financial Statistics

DJIA: 10856.63

S&P 500: 1169.43

90-Day T-Bill: 0.15%

30-Yr. T-Bond: 4.71%

Approximately eight weeks ago, in an effort to save over one million dollars annually on operating and maintenance costs, more than a third of the street lights in this city went dark. A short while earlier, in an attempt to blunt a gaping hole in its budget, the city's police helicopters were put up for auction. In addition, firefighting jobs were also being cut, along with reductions in all-important law enforcement jobs (vice, burglary and beat cops, to name a few). Even the parks department, which was spending nearly $20 million per year before the recession hit, was not immune to cutbacks. As an example, trash cans have been removed from city parks, replaced by signs urging citizens to pack out their own litter. (In total, the parks budget is being slashed to a modest $3.1 million in 2010.) In addition, green spaces are now scheduled for major cuts in water, which could leave grass dead and brown by summer (even the flower and fertilizer budget has been eliminated). Unless private funding surfaces soon, city recreation centers, indoor and outdoor pools, and a handful of museums there are scheduled to close for good. Adding insult to injury, city bus service no longer runs on evenings and weekends and, going forward, the city won't pay for <u>any</u> street paving, relying instead on a regional authority that may only be able to meet about 10 percent of the need (at least the resulting potholes may prove a boon to auto mechanics there). All of this comes against a backdrop of still-severe economic distress which has hammered sales-tax receipts while, at the same time, pension and health care costs for city employees have continued to spiral ever higher with no end in sight. Last November, in an emphatic vote of no confidence in the city's government oversight, voters categorically rejected a tripling of property tax that would have restored nearly $28 million to the city's $212 million general fund budget. Going forward, wholesale changes to the way the city operates are now being considered, with officials pondering the possibility of selling off (privatizing) local utilities, a hospital, etc. Virtually nothing, it would appear, is off-limits.

Despite what some readers might presume at first blush, the city in question here is <u>not</u> the once proud, but now famously beleaguered, "Motor City" of Detroit, Michigan. It is, instead, an ultra-scenic community nestled at the base of the majestic Rocky Mountains that was once held in such high esteem that, only four short years ago, it was selected by *Money Magazine* as the No. 1 Best Big City in its annual "Best Places to Live" rankings. In addition, the economy of this medium-sized metropolis has been cushioned for nearly seven decades by a uniquely ubiquitous and massive military presence. In other words, it is a place not short on positive attributes and special advantages.

So, let's end the suspense. The fair city to which we're referring here is none other than – Colorado Springs, the second largest city in Colorado. Surprised? Well, unfortunately you shouldn't be. **The scenario playing out there may portend the shape of things to come all across this great country of ours** (and possibly beyond – i.e., Greece, Portugal).

As professional investors, we are constantly on the look-out for companies with a strong history and proven track record of shareholder-friendly capital allocation. Such companies, ***if bought at the right price/valuation***, have typically proven very productive and highly satisfactory investments over extended holding periods. To the contrary, unlike the savvy caretakers presiding over such *best-of-breed* companies, federal, state and local governments have not been so careful and judicious with taxpayer (stakeholder) money — not by a very, very long shot! For much too long, elected officials all across the country have not been held sufficiently accountable for their all too frequent misallocation of resources and sometimes reckless oversight of the people's hard-earned tax dollars. However, as things stand today, it doesn't take an heroic effort or intellect to grasp the reality that a <u>tipping point</u> is barreling closer by the day (if not already reached).

Continued on inside...

...Perdition?

"The future ain't what it used to be."
–Yogi Berra, New York Yankees Hall-of-Fame catcher (1925 to present)

A recent perusal of the web site of Congress's own independent and non-partisan investigative watchdog group, the U.S. Government Accountability Office (GAO), led us to a report that is quite literally a "jaw dropper." Even more disturbing, the report posted there, as far as we can tell, is not something the media has chosen to proactively highlight to the American people. In fact, we recently conducted a very basic Google internet search and, to our chagrin, did not unearth a single story by a national, regional or local news organization on this long-evolving development. Such an omission strikes us as quite ironic given the widely-reported lambasting recently delivered to banking and Wall Street executives by members of Congress. Although in absolutely no way do we approve of the shenanigans and malfeasance perpetrated by some of those so-called "titans of finance" leading up to the financial meltdown of 2008, it seems a hypocrisy of the worst kind for Congress to publicly grandstand and point fingers at Wall Street when, at the same time, the financial house they are charged with policing (and protecting) appears to be crumbling from within. Here's an example of what we mean.

On February 26th of this year the Comptroller General of the United States, who presides over the U.S. Government Accountability Office (GAO), wrote a letter to the President of the United States and to the Congress updating them on the financial status of the federal government (as is done by protocol each year). Included in that letter was the GAO's report on the U.S. government's consolidated financial statements. A summary of the press release which accompanied the report follows:

"The U.S. Government Accountability Office (GAO) could not render an opinion on the consolidated financial statements of the federal government (other than the Statement of Social Insurance) because of widespread material internal control weaknesses and other limitations. For the 13th year in a row now shortcomings in three areas again prevented us from expressing an opinion," said Gene L. Dodaro, Acting Comptroller General of the United States. "I'm referring to serious financial management problems at the Department of Defense (DOD), the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between agencies, and the ineffective process the federal government uses to prepare the consolidated financial statements."

Dodaro went on to caution that: "The material weaknesses discussed in the GAO's audit report hinder the government's ability to: (1) reliably report on many of its assets, liabilities, and costs; (2) accurately measure the full cost as well as the financial and non-financial performance of certain programs and activities; (3) adequately safeguard significant assets and properly record various transactions; and, (4) have reliable information to operate efficiently and effectively. Long term, the federal government faces huge structural deficits driven by rising health care costs and demographics. Focused attention from Congress and the administration is needed to address these problems and put the government on a more sustainable path."

Take a moment or two to digest what you just read and then consider this: **If the federal government had been a publicly-traded corporation, such scathing disclosures would very likely have triggered an avalanche of sell orders in its stock quicker than a five-year old can recite his or her ABC's**. On Wall Street, such highly cautionary language would have been big news and, of course, would have been widely reported across the globe. However, inside Washington's often clubby and insular beltway, and amongst the media elites that cover it, such news was (apparently) not deemed even remotely newsworthy. Sadly, this should not come as a surprise.

"Politicians are like diapers. They both need changing regularly and for the same reason."
–Mark Twain

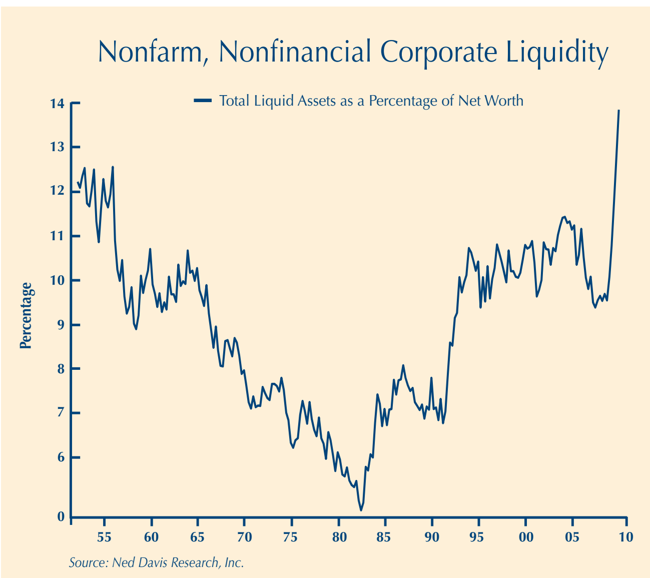
Economic and accounting theory (and, most importantly, real world experience) suggests such financial mismanagement cannot persist indefinitely without serious consequence. Although some may believe the still on-going monster-sized rally in U.S. equities off the early March 2009 lows indicates these concerns are likely overblown, **the collective fiscal health of government, both big and small, will inevitably matter to investors (and possibly in a big way)**. Just ask the Japanese.

With that in mind, given the uncertainties and stresses that abound today (and those that we will surely face in the future), we strongly believe it behooves investors to proactively prepare for all possible economic and fiscal outcomes (especially those punctuated with negative surprises). In other words, we believe prudence suggests *investors, especially those with very long time horizons, need to take the necessary steps to ascertain that the stocks (and therefore the companies) they own possess the financial and qualitative underpinnings necessary to give them a real fighting chance of controlling their own destiny*. Put another way, we believe it's prudent for investors to favor the stocks of companies, **especially those whose valuations are historically depressed**, that possess the requisite core attributes, per the mantra of business consultant and author "Jim" Collins, which imply they've been "**built to last**." Nowhere is it written that the financial system fracture that seismically jarred the markets beginning in September 2008 is a once-in-a-lifetime aberration. Although we're not endeavoring to be overly alarmist here, given the increasing magnitude of government deficits worldwide, *it's possible that the next such crisis could be even worse than the one we've just lived through.*

As the increasingly uncertain future we've outlined here unfolds, the wheels of commerce go on churning undeterred (no matter the economic backdrop). At its core, business thrives or dies based on its ability to dynamically adapt. It is that inherent capability which contains a very important lesson and one that is, in essence, *hidden in plain sight*.

Despite coming off one of the most severe economic contractions and financial market dislocations since the Great Depression, corporate America is flush with cash (industrial companies in the S&P 500 held $832 billion in cash and short-term securities at year-end, up 27% year-over-year). In fact, as of year-end, liquid assets as a percent of net worth stood at levels not seen over the span of the past six decades or so (see **Chart 1**). To the contrary, despite this prolific stash of corporate dry powder and liquid reserves, **federal, state and local government deficits are at generational highs and growing while their liquidity is increasingly being squeezed**. How did this unfortunate circumstance evolve?

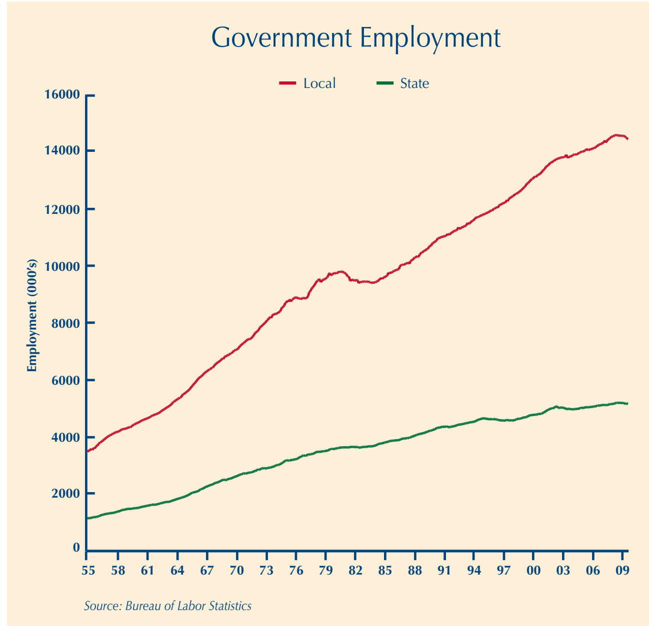
Chart 1



The relatively obvious answer is steeped in common sense (or the lack thereof depending on your perspective). Unlike government entities of all sizes, especially at the state and local levels, which, over the past 55 years, have persistently opted to increase their size and scope (see **Chart 2**) and, as it relates specifically to the federal government, print huge sums of money to sustain the aforementioned unfettered increase in government spending (and employment), businesses have been driven by two much more powerful and potent forces: **the profit motive** and the all-engaging **survival instinct**. In other words, in the world of business, Darwinism – survival of the fittest – rules. *To the contrary, such worthy and under-appreciated incentives are blatantly absent at the core of the institutions that are charged with managing and overseeing our tax dollars and related government infrastructure.*

Earlier we highlighted the once comfortably solvent city of Colorado Springs and its now rather sad state of fiscal affairs (alluding, in turn, to the potential coming torrent of fiscal

Chart 2



train wrecks among cities and towns, big and small, all across America). Though the ensuing pain from such fiscal wake-up calls will likely be intense and far-reaching, *the result of such long overdue belt-tightening and rationing could ultimately prove to be just what the doctor ordered*. Let us explain.

For decades, **restructuring has become a way of life in corporate America**. Good economy or bad, shareholder-driven corporations never seem to rest when it comes to further optimizing their operations. (Don't tell them you can't squeeze blood from a turnip. They know better.) From the perspective of long-tenured analysts like us, whose business it is to study financial statements for a living, it's quite remarkable how, no matter the degree of lean achieved by a properly incented work force, *more efficiencies and costs seem to be extracted each and every year throughout corporate America*. This, it appears, is the nature of the beast. As a result, we believe **such results, given the emerging fiscal reality chronicled by the Colorado Springs example, could also be achieved, to a degree, in the government realm**. A worthy and notable case in point follows.

Deep in the heart of Dixie, in a suburb outside Atlanta, a seed was planted a few years ago that could, in time, spawn a relatively untapped "horn of plenty" across America's fruited plain and beyond. On December 1, 2005, the seventh largest city in the state of Georgia (population: approximately 100,000) was born. Sandy Springs, unlike other cities and towns operating under the same old inefficient and unresponsive local government business model that has remained largely unchanged for the past 100 years, broke the mold. In June 2005, following a long sought and successful referendum to approve incorporation, the residents of the city-to-be had only a few likely very hectic months to be up and running by the legally mandated start date of December 1. However, in addition to the very tight time constraint, they had an even more significant problem. *By law, until one minute after* *midnight on that date, there were legally no funds available to start the city, and no one would have the authority to hire, make contracts or any expenditure, for that matter.*

Facing this daunting dilemma, the city's organizers quickly mobilized a highly innovative "out-of-the-box" approach. **The solution: partner with private industry for virtually all the city's services, excluding public safety, to meet the citizens' needs**. No other U.S. city or town, as far as they knew then, had ever done this in such a comprehensive way. Fortunately, the task force charged with this rather overwhelming undertaking was being led by Oliver Porter, a retired corporate executive and very active volunteer (and a past national chairman of the National Kidney Foundation) who possessed a storehouse of relevant experience and energy. Porter, by virtue of his many years in the corporate world, was familiar with the capabilities and resources that major companies could offer a city like Sandy Springs. As a result, in a matter of a few months, with the help of other volunteers, Porter issued RFP's to cover a wide variety of necessary functions and services such as administration, accounting, finance, purchasing, information technology, human resources, backroom support for the police, fire and municipal courts along with planning, zoning, permitting, code enforcement, parks and recreation and public works.

Lacking legal authority to consummate contracts until December 1, and in order for the city to be able to hit the ground running on that date, the firms bidding on the RFP's were, in many cases, required to spend millions of dollars to hire staff and provide materials and facilities months before the contracts were presented to the city for approval. Despite these and other significant challenges however, "when the clock struck one minute after midnight on December 1, 2005, the newly elected Mayor and City Council were seated with a full agenda of statutes, codes, contracts and other critical matters to act on."

Sandy Springs has been a success from day one. Within the first year, a large police force and fire department were established in addition to a wide scope of services provided under the ground-breaking *public-private partnership* (PPP). The city has now been efficiently running for over four years and, impressively, has experienced a sizeable cumulative multi-million dollar operating surplus of revenues over expenses since inception. This was achieved despite the severe economic downturn last year, which hit Atlanta and the greater Fulton County area particularly hard, while, at the same time, the city has built a significant rainy day reserve exceeding $20 million. In terms of citizen feedback, it has been overwhelmingly positive.

Although space constraints prevent us from providing too many details here, we can highlight that in the four-year time span since incorporation, "Sandy Springs has paved more roads in its community than the county had in the past 20 years, created new parks, established a 125-person police force, and hired 89 firemen," outfitting them with all new equipment. In addition, the upstart city has vastly improved EMS capability, and has established a joint state-of-the-art 911 service with another nearby community. A much-needed modern traffic control system has also been installed while the city has gained control over zoning, planning, permitting and code enforcement. The list of improvements is very extensive, and, of particular relevance to the citizens there, **"all of these changes have been implemented without tax increases. In fact, the city's taxes are actually lower than the taxes on the unincorporated areas of the county" where it resides**.

Skeptics would likely make the case that Sandy Springs was unique in that, unlike a long-standing city or town, it started with a near-literal clean slate (i.e., no embedded legacy costs and retiree obligations). However, despite the inevitable political opposition that would likely arise if such precedent-setting restructuring moves were proposed in long-established municipalities, Porter firmly believes such cities and towns <u>can</u>, like Sandy Springs, achieve real and impactful fiscal and operational success through comprehensive *public-private partnership* reform.

After receiving positive feedback from a number of cities around the country, Porter recently authored a book on the subject which provides a road map for cities, towns and counties to transition to this new business model (*Public Private Partnerships for Local Governments*). In fact, a preliminary draft of a joint study conducted by Porter and the Georgia Institute of Technology, which compared five PPP cities with five traditional cities, showed "that in every case the PPP city had a lower cost per capita than the comparable traditional city." Of particular note, "the average cost per capita of the traditional cities was 128% higher than the cost for PPP cities!" Building on the success of Sandy Springs, Porter has gone on to consult with four other new cities in Georgia which all chose to follow his PPP model. In addition, he has spoken extensively in Japan, a demographically-aging country where city after city is burdened with *extraordinary indebtedness*, about applying his PPP model to help address the enormous fiscal challenges there. In that regard, a Japanese pilot city of 50,000 was recently identified to be a beta site to introduce the Sandy Springs model to Japan for the first time.

As long term fiscal stresses inevitably build at the state and local level (i.e., huge unfunded pension obligations), not to mention the gargantuan obligations still accruing at the federal level (i.e., Medicare and Social Security), innovative and decidedly tough-minded decisions will very likely have to be made in order for government entities of all stripes to reach self-sustaining levels of operations over the longer term (even if the economy sustains recovery). As noted earlier, *corporate America provides a well-tested and potentially highly applicable template for these heretofore slow-moving and hide-bound bureaucracies to follow as they face the still-evolving fiscal crisis of a lifetime*. However, unlike small businesses and large-scale corporations that, as a matter of routine, adapt and restructure year in and year out, government has no real history of such dynamism. *There is, however, a silver lining in that regard.*

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As a result of the many decades of neglect, and the huge redundancies which have built up concurrently, the restructuring opportunities, and the potential benefits, could prove massive in scope and magnitude. In addition, existing cities and towns typically own valuable assets that can be monetized and sold (e.g., Chicago is aggressively pursuing a multi-billion plan to privatize Midway Airport there). If such governmental privatization eventually takes hold across the country, it could prove to be a long-tailed boon to private enterprise as well.

"When it's all said and done our elected officials will be forced to govern and to make the hard choices we've dodged for so many years."
–Winston Churchill

Although we're not holding our breath, practical reality suggests to us that at some point over the next decade or two, hopefully sooner rather than later, Churchill's discerning critique, like so many he uttered during his lifetime, may finally hit the mark (as harsh fiscal realities are inevitably addressed). *If not, the title of this quarter's newsletter may prove more, possibly much more, than simple metaphor*. In the meantime, **a word to the wise: when you invest, make sure you "measure twice before cutting" and, by all means, don't forget to guard your flanks**. Good luck.

Index	3/31/10 Price	1st Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	10856.63	4.1%	4.1%
S&P 500	1169.43	4.9	4.9
Value Line Composite	334.54	8.3	8.3
American Exchange Comp.	1906.98	4.5	4.5
NASDAQ Composite	2397.96	5.7	5.7

*Does not include dividend income.

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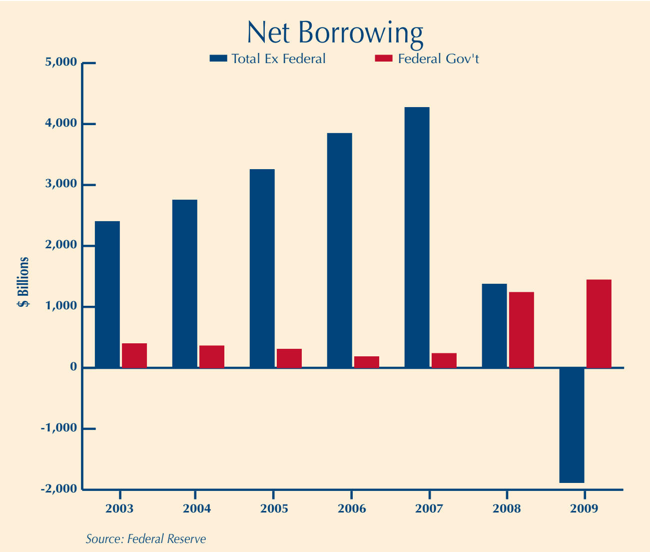
Fixed Income

Crowding Out and Crowding In?

A year ago, we wrote in these pages about the exploding Federal budget deficits in a piece entitled, "Deficit Attention Disorder." In it, we referenced a relatively obscure government publication, one of the primary themes of which was that current fiscal policy is not sustainable in the long-term. Published in December 2008, *it noted that net interest on the Federal debt would eventually become the largest budget item if then-current trends continued, dominating other areas of spending such as Social Security, Medicare, and national defense.* **With the passage of another year, along with a deep recession and even higher Federal spending, the unsustainable path is now even more steep.**

Our purpose here is not to sound the alarm again, but to look at the virtual certainty of the ever-increasing supply of U.S. Treasurys from several points of view. First, in economics, "crowding out" refers to the concept of deficit financing supplanting private demand for debt capital. Currently, with private credit demands dramatically subdued, the bond market hasn't had too much trouble financing the massive deficits (especially with the help of the Federal Reserve!). However, *concern will likely arise when private credit demands return, possibly leading to much higher interest rates.* A glance at **Chart 3** shows how dramatically non-Federal net borrowing has fallen during 2008 and 2009. By contrast, Federal net borrowing has surged over the same time period. Even as the economy recovers, it may be awhile before substantial non-Federal credit demand returns in a meaningful way. Indeed, the "private" sector may continue to de-leverage for several years, given the hangover from the housing bubble.

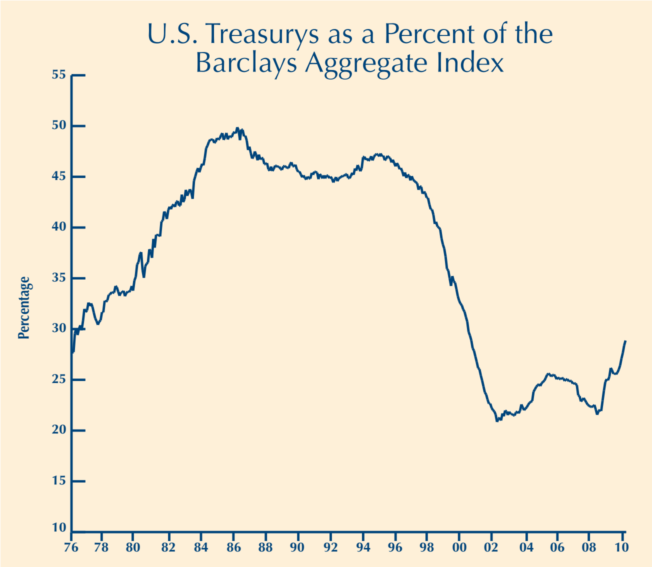
Chart 3



Source: Federal Reserve

Perhaps an underappreciated aspect of the scale of Federal borrowing is its impact on the major bond indexes. **Chart 4** shows the percent of U.S. Treasurys in the Barclays Capital Aggregate Index. It is interesting to note that even with today's outsized Federal deficits, Treasurys made up a much larger percent of the Index in prior years, basically from inception until mid-2000. But it is also evident that the percent of Treasurys has reversed course and is now rising rapidly, and is likely to continue this pace, particularly if private credit demand remains subdued (most specifically in the Federal Agency mortgage-backed securities area). Indeed, U.S. Treasurys are increasingly "crowding in" to the Index!

Chart 4



Source: Barclays Capital

As always, we will continue to monitor these trends. For now, however, one thing seems obvious – *at the margin, private credit risk remains in severe decline while public credit risk is soaring.* With all of the government intervention in the capital markets during the last few years, an enormous amount of private credit risk has been transferred to the public sector. From our perspective, **this begs the obvious question: will this dramatic shift ultimately lead to a further narrowing of credit spreads going forward?** *Needless to say, only time will tell.*

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