Tradewinds
GLOBAL INVESTORS

SLUMDOG MILLIONAIRE

We follow our last Commentary, which centered on the runner-up in this year's Academy Awards, with one inspired by the film that took home the Oscar for Best Picture last year. As usual, I've found an investment message in a film. This film is filled with imagery.

I'm usually not much of an Academy Awards fan. Although I love the movies, I usually don't care for events involving people from any industry spending hours publically congratulating each other. 2009, however, was an interesting year, perhaps reflective of the depressed mood surrounding the financial meltdown. I actually saw all five movies (yes—it was the last year before the Academy took a page from the NBA playbook and allowed almost everyone (save the Clippers and WALL·E) to make the playoffs). Am I the only one who finds 10 candidates excessive?

Hollywood put out four movies ending with dour outcomes, mostly death. The fifth contender was an outsider, a British film, shot in India. It, too, is filled with depression and death. Yet unlike the others, it is also about hope, perseverance, and the triumph of the human spirit. I like upbeat endings and was definitely rooting for Slumdog to take down the award. Yet, the award, like the movie, stirred mixed emotions. For example, what does this mean for America? I was born in a year of American pre-eminence in many things. There was auto manufacturing for example ('57 Chevy, T-bird, etc), but I was still a teen when the Japanese companies began to steam-roll us. We've since witnessed America's loss of businesses such as consumer goods, TV and electronics, resource industries and, more recently, even some service businesses. Unpredictably (I suppose), I'm not going to lament the continuing loss of our hegemony in the film business. No, the question preoccupying my mind is, "**when did we outsource the American Dream?**"

GABI RONA/mptvimages.com

"WHO WANTS TO BE A MILLIONAIRE?"

The meaning of millionaire status is a worthy and apropos topic in 2010. Who among us wasn't rooting for Jamal during his quest to win the prize? And how could we not feel his joy and the joy of the country's citizens when it all fell into place. Seeing a country filled with enthusiasm and hope for the future reminded me of the USA of my childhood. In an era predating "Watergate" and the height of the Vietnam War, children would walk home from school (or get off the bus), play baseball in the street, and watch goofy but upbeat TV shows such as "I Dream of Jeannie," "Lost in Space" and "Gilligan's Island." The latter features a Hollywood actress, a Professor, a Skipper, a beautiful tropical island, and more. A whole list of inspiration for a child's dreams of the future. And perhaps most inspiring, there was "the Millionaire and his wife," Thurston and Lovey Howell! They lived in a Beverly Hills mansion, traveled the world, and had every material possession imaginable. They had servants, were accustomed to being waited on and had no legitimate worries. How they ended up on the Minnow, who knows, and why they packed so many of

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their possessions to go on "a three hour tour," is a detail that only a Hollywood writer could conjure. But, being a millionaire circa 1965 was something to which we could all aspire.

Yet, less than half a century later, it is not at all the same. Anyone sitting on a million dollars in 2010 is still blessed. They should thank God daily, acknowledging that they have a level of security and freedom that most of the world's population will never have. But, they have not "hit the big time." Most houses in Manhattan or Beverly Hills cost multiple-millions. As for the mansions and yachts—forget about it! Suppose a millionaire has a spouse, two kids, house payments, tuition and insurance payments, and all the other costs of living. How should he/she invest their million to cover expenses? As the table below highlights, this is not an easy task.

LIFE AS A MILLIONAIRE

$1,000,000

Interest Rates	Annual Income
0%	$0
0.5%	$5,000
1%	$10,000
1.5%	$15,000
2%	$20,000
2.5%	$25,000
3%	$30,000
3.5%	$35,000
4%	$40,000
4.5%	$45,000
5%	$50,000

It becomes clear immediately that our would-be entrant to the upper class has become a victim of Messrs. Greenspan, Bernanke, and Geithner et al.'s scheme to transfer wealth from savers to debtors. While a zero percent cost of capital has obvious appeal to American debtors, it means that the investment return on $1mm invested in short-term T-bills is also in the neighborhood of zero. This will, in turn, help fund approximately **none** of one's obligations. Of course, he or she may have a bank that pays 1% or even 2% on deposits, yielding $10 to $20 thousand before tax. A ten year Treasury will generate around $25K annually pre-tax and 30 years throws off $35K before the government's take. Far from feeling rich, our millionaire may be considering a second job. How did this happen? First, Federal Reserve's interference with interest rates does not help the economy; it merely transfers wealth from savers to debtors.

"Bona fide hustler making (it's) name
All (they) wanna do is (bang bang bang bang)
And (kkkaaaa ching!)
And take your money"

-MIA from the 'Slumdog' soundtrack

Secondly, our government's management of our fiat currency has resulted in a loss of purchasing power exceeding 90 percent over the past half-century. In other words, the millionaire circa Gilligan's Island is equivalent to a deca-millionaire now (and probably the hecto-millionaire of the not too distant future). It is likely even more pronounced if one believes that purchasing power has declined even more than what the CPI fesses up to. I believe that Barron's last year published an article referring to families with under $25mm as "beer and pretzel" millionaires. Because it is highly likely that debasement over the next half century will be no less than it was during the past half-century, Tradewinds suggests that in addition to **preservation of capital**, investors must be mindful of **preservation of wealth**!

RANDY BISH - Tribune-Review

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Before we continue, let's veer off on a tangential discussion about why a disciplined bottom-up, value-oriented shop like Tradewinds spends time on these broader issues or sends out these topical missives.

I must confess to being a big fan of Charlie Munger, whom I've never met. He writes often about the importance of psychology, behavior and incentivization. He talks about a thorough understanding of accounting, mathematics and finance, not as an advantage but, as a necessity. Tradewinds agrees. We don't believe that anyone ought to hire a money manager because they understand accounting and finance, but they surely shouldn't hire them if they don't. An appropriate analogy is a sports team. A team won't win a game solely because they are in shape and have a decent playbook, but they likely don't have a chance if they aren't fit and don't have plays. To excel, it is important to have a good coaching staff that has studied the other team and has developed a strategy to exploit its weaknesses. It is important to practice, to execute, to have the right attitude and desire. It is important to have talented players. Likewise, in the investment business, so many of us like to classify ourselves as 'value' investors or as 'bottom-up' investors. Tradewinds does not consider these approaches to be advantages; **we view them as prerequisite! Overpaying for investments and/or buying franchises without thoroughly vetting the fundamentals is a tough way to make money.** It is certainly no way to steward other people's money. In addition to these fundamentally obvious disciplines, we believe that it is important to understand economics, psychology, behavioral finance, history and logic. A global, independent thought process is increasingly important. Conviction is necessary and integrity is an absolute prerequisite! Putting clients' interests ahead of one's own business interests is an unfortunately rare characteristic, and yet is so fundamentally important.

This was a necessarily long intro into the concept of bubbles. *While bottom-up analysis and valuation remain absolutely prerequisite to sound investing, doing so while remaining oblivious to bubbles and other major dislocations in the economy equates to the proverbial 'rearranging of the deck chairs on the Titanic.'* In 1929, it really didn't matter what stocks you picked, what mattered was that you shouldn't own stocks. During the 'guns and butter' days of LBJ, not owning bonds for the next fifteen years was much more important than picking the 'right' bonds to own. In 1980, with Paul Volcker reining in the money supply, getting out of gold, oil and other commodities should have been at the forefront of everyone's mind. In the late 1980s, asking if there was any conceivable way that things could work out well for the Japanese market was all that mattered, rather than analyzing which Japanese stocks or buildings to own. In 1999, recognizing that there was no growth rate high enough to make the math work for investors in tech stocks was all that needed to be done. Analyzing tech stocks was generally a waste of time until 2002 (except for short-sellers). During the 2005 through 2008 period, asking the question - will mortgages on overpriced houses, extended to unqualified, over-extended borrowers likely be repaid? - was all that analysts needed to do when assessing financial stocks.

Which brings us to 2010! *We believe that the most important analysis that a prospective investor can perform is to ask the question: will governments that have obligations that far exceed their wherewithal to honor, eventually make good on them?* If you were considering making a loan to your neighbor for 10 years, you would want some data. High on the list might be: other obligations, integrity, employability, assets/collateral, and income. Low on the list (if there at all) might be: what do the government bureaucrats claim was the CPI or unemployment rate last quarter, what was the 'output gap,' whether Bernanke is speaking this week, or what economists are suggesting next quarter's growth rate will be. Why should loans to governments be treated differently? That Japan, the U.S., and the U.K. won't honor their commitments is a given in our opinion. When and how they renege is a more legitimate topic. We do not know the answer, but not knowing the answer, we do believe that loaning money to them for 10 years at a sub-3% yield is madness! While it may or may not ultimately work out for buyers, the risk is far greater than the prospective return.

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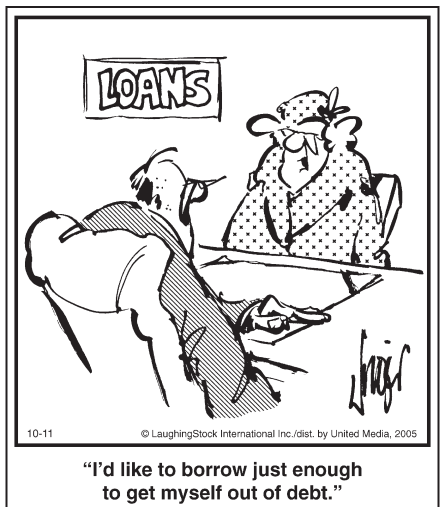
HOW DID WE GET IN THIS MESS?

"Once upon a time, I had a little money
Government burglars took it...
Blame it on Keynes
Please don't blame it on me
It's nobody's fault
But it just seems to be his turn."

- Elvis Costello

Taking artistic license with Elvis Costello's catchy tune "Blame it on Cain," it is all too easy to blame the current mess on Keynes. While it is clearly not his fault, his theories have, I believe, provided massive cover for government bureaucrats and other politically minded types, hoping to employ horribly misguided and destructive policies. Let's start with Y = C + I + G (where Y = Notional Income, C = Consumption, I = Investment and G = Government Spending.)



"I'd like to borrow just enough to get myself out of debt."

HERMAN: © Jim Unger / Dist. by United Feature Syndicate, Inc.

Therefore, all other things being equal, an increase in government spending leads to higher notional income. What elected official wouldn't love the idea that if he spends more of our tax dollars, he is adding to our economic well-being? The concept that the government can act as a stabilizer by employing deficit spending during weak economic times and subsequently withdrawing stimulative spending, while running a budget surplus during more prosperous times, is intriguing. Whether or not the concept is valid is not what is important. What matters is that it is easier to get a heroin addict to give up drugs in the future than it is to get a government to give up future deficit spending! Like most junkies, they don't stop when things improve.

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Next, notice the importance of consumption in the model. This is a mixed-up notion in our opinion. Income can be produced and it can be consumed. Producing things makes us wealthier; consuming our wealth makes us poorer. This is as true in aggregate as it is for individuals. Notice Keynes' formula suggests the opposite, that consuming more makes us wealthier. This notion seems to have infected Wall Street as well. They celebrate when consumers spend more than they make and go into despair when they don't, or even when consumer confidence drops. Seems to us that increased spending is primarily good for companies in China, and elsewhere.

WHERE DO WE GO FROM HERE?

JAI HO!

Merely whining about the current situation is ineffective at best. As an American, I'd like to see us return to sound values, more production and less consumption, a hard currency and a government that doesn't have the authority to saddle our grandkids with debt. If we must spend, why not invest in our future: energy independence, modern airports and roads, education, water conservation and mass transportation?

Jai Ho, the Oscar winning song from the movie, seems to have many translations, but seems to mean something along the lines of "May victory be yours." Just like this song of triumph over adversity at the end of the film, as investors we need to have perseverance and a sound strategy to triumph over a particularly threatening environment. We need a strategy to protect our wealth. While cash has a place in every portfolio, the current de minimus yield and the risk of "quantitative easing" dictate that it should not be an extraordinarily large piece of the pie. Bonds? Enough said already. Stocks? Time for another tangent!

In 1979, my senior thesis used a version of CAPM (the Capital Asset Pricing Model) to correlate various asset classes with inflation. I received an A+, benefiting from the fact that I was too green to understand that CAPM is seriously flawed; CPI is a horrible proxy for inflation; and projecting past returns into the future is dangerous. I "proved" that bonds were bad, stocks were very good, and commodities were great. Good thing I was handing my results to a professor for a grade rather than a portfolio manager to implement. Since that day, bonds have been the best investment, commodities the worst. Extrapolating the past was a big mistake (as it always is at major inflection points). At that time the government and the public were hell-bent on whipping inflation. Somewhere out there now, a young student is industriously proving that bonds work best during deflation, stocks don't, and commodities, in technical terms, are dismal. They are following in my missteps by not noticing a major inflection point. Our government, many other governments, the Fed and the public are all fully committed to **reflating**. Betting against them is a dangerous proposition. If/When the current reflationary efforts gain traction, commodities likely will be the best asset class. But we've pounded on that theme enough. Let's talk stocks.

"Well, she was an American Girl
Raised on promises
She couldn't help thinkin'
That there was a little more to life somewhere else
After all, it was a great big world
With lots of places to run to."

- Tom Petty

Rather than talk stocks, let's talk about businesses. After all, stocks represent partial ownership in the underlying businesses. And while "stocks" face challenges during extreme environments (whether they be inflationary or deflationary) some businesses do well while others do not. Tradewinds endeavors to understand and appraise businesses and industries.

Before returning to the U.S. to discuss some of the many wonderful companies and attributes that still reside here, let's discuss some other regions that may now be embracing their own version of the "American Dream". After all, "it's a great big world with lots of places to run to."

Let's start with Japan. I believe that they currently have much in common with the U.S. circa 1949. Yeah, yeah, I know, there are big differences too. They haven't just won a world war resulting in a role as the dominant military power of all time, they aren't one of the only countries that weren't decimated by the war, they don't have promising demographics and they don't have a gold-backed currency.

Yet, like a post-war America, they are worried about their economic prospects. Like post-1929 bubble, multi-decade depressionary America, the post-1989 bubble, subsequent multi-decade recessionary Japan is afraid of stocks, afraid of leverage and reluctant to invest in the future. Other important similarities include the facts that: stocks are very cheap; balance sheets are strong; the society believes strongly in thrift, education, quality, and creating a better future for the next generation. From an investment standpoint, with the exception of a few months in 2002 "tech land," I thought Ben Graham's net-net company (stocks selling for less than cash net of a debt) was no more likely to reappear on this earth than was the pterodactyl. Yet, figuratively, investing in the Japanese stock market is like visiting Jurassic Park. These formerly extinct beauties are everywhere. Tradewinds doesn't often find stocks "with a catalyst," but here they are. In our opinion, managements have the ability to create wealth "out of thin air", merely by taking money out of the bank (where it is yielding nothing) and buying their own stock (or that of other companies) at huge discounts to book value and at earned yields of 4 or 5%, plus growth. They are smart; they will likely get around to it. We are more than happy to own these companies while we wait for a Japanese "Drexel Burnham" or some other instigator to emerge.

Russia gives us pause. All the same, America prospered as we harvested our abundant resources such as oil, gas, coal, copper and arable land with nutrient rich topsoil. Russia is endowed with a large share of the world's natural gas and palladium. They have a lot of oil and nickel. They have forests, rivers, farmland, gold and much more. They stand to benefit from the world's expanding population and from the world's surging money supply. Hopefully they will embrace a fair, equitable, consistent rule of law. At any rate, many Russian stocks are quite cheap.

Similarly, the Middle East is well endowed with oil and gas. Some of the countries are making strides in terms of their rule of law. Like the America of the mid-20th century, they are deeply religious. At any rate, while it is difficult to invest there, Middle Eastern stocks are priced attractively.

Likewise, many countries in Africa and Latin America are blessed with incredible resources. Those that can maintain a sustainable, equitable social order have a bright future ahead of them.

Asia is much too big and diverse to really be thought of as one region. It represents much of the worlds land mass and most of its people. It, undoubtedly, will represent the lion's share of the globe's economic growth in coming decades.

"If you don't do it, I know some guy in India who will."

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Watching the perseverance and hope exhibited by Jamal Malik and Latika (in Slumdog) it seems like a Horatio Alger story. Likewise, the popularity of the game show and the public's rallying around Jamal seems reminiscent of the $64,000 Question in 1950's America. There seems to be a belief in the future across much of Asia. Like Japan, Korea and Taiwan before them, many countries are converting an ethic of thrift, hard work and education into their own version of the "American Dream". The result has been strong economic growth and a strongly growing middle class. This week's Economist (August 28, 2010) shows back to back years ('10 and '11) of expected economic growth exceeding 4% for nine countries in Asia (plus four in Latin America, Russia and Egypt). Tradewinds is happy to own many franchises that cater to meeting the needs of their emerging middle class. We'll take them (at current prices) over bonds any day.

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Europe and the U.S. are interesting from a common stock perspective. While they sometimes appear to be embarked on a path of slow and steady decline, it is not necessarily as bad as it may sound for equity investors. First of all, while many countries have a much more promising outlook, they also entail a higher likelihood of materially worse outcomes. Secondly, the developed markets, having recently under-performed, offer some attractive valuations. Thirdly, and perhaps most important, Europe, and particularly the U.S., still maintain environments that allow for creativity and entrepreneurship, rule of law, and private property rights.

"I was hoping my life would fit the rags to riches mold. Instead I've had to settle for rags to large amounts of unsecured debt."

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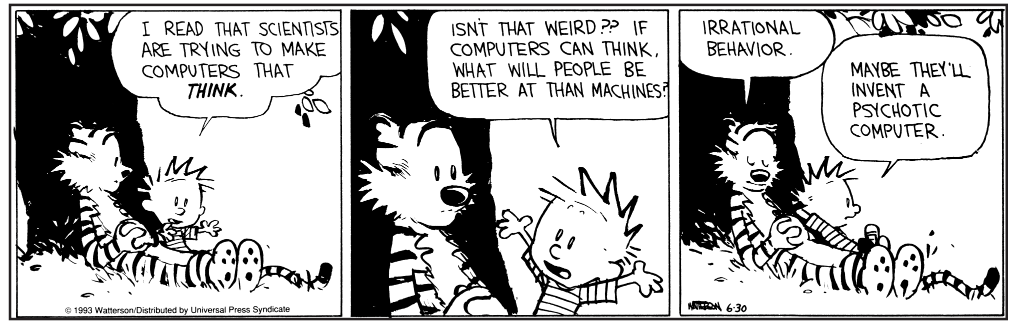
From a bottom-up vantage point, many of the best companies, in the best industries, worldwide, reside in the west. For example: agriculture, food, capital equipment, water technologies, software, business services, entertainment, and aerospace and defense. Many strong oligopolies, selling products into important markets, with reasonably priced equities, are domiciled in the States, Canada and Europe.

CONCLUSION

In conclusion, we live in fascinating, if difficult, times; times which, more than ever before, require attention to preservation of capital **and to preservation of wealth (purchasing power)**. Cash, we fear, does not possess this attribute. Bonds increasingly appear to constitute "return-free risk," as several well-known wags have phrased it. And stocks and commodities assuredly portend extreme volatility going forward. We fear that many consumer and industrial stocks are pricing in some unlikely positive outcomes, making them quite vulnerable. Recent computer "glitches" only add to the anxiety and to the probability of volatility. Surely, investing will be more challenging over the next three decades than it has been over the past thirty years.

Yet, it is "a great big world, with many places to run to." Tradewinds' believes that investors ought to dismiss the idea that volatility equals risk, and invest in businesses that should protect and create wealth over time. We continue to believe that everyone should allocate a portion of their portfolio to precious metals and other hard assets. Additionally, they should own a diversified portfolio of businesses (via common stocks). We prefer businesses with strong franchises to those with weaker positions. We are interested in companies that sell goods and services that the world



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needs, while typically avoiding those that peddle things of which the world already has enough. (Those selling goods with which the world is awash should be shorted.) And, of course, investors should be deeply concerned with value. Last but not least, diversification is extremely important in this perilous environment. This is not a good time to concentrate on any one country or one industry.

Tradewinds is encouraged that there is so much bearishness toward stocks, especially in light of the fact that stocks are now lower than they were over a decade ago! We are happy to purchase great franchises in the U.S., Canada and Europe at reasonable levels. In addition, we are accumulating companies with great growth prospects elsewhere around the globe. As I finish this commentary while touring the wonderful country of Sri Lanka, I am reminded of a quote by Jim Rogers, an outstanding global investor whom I've long admired. "*Scout for nations that are living up to the ideals and principles that made our country (U.S.) great–namely, those with unshackled economies and free markets.*"

Hopefully we can look forward to more of those ideals and principles worldwide. In the meantime, we hope you all had a nice summer and have a great finish to yet another extraordinary year. Thank you all for your continued support.

Cheers.

David B. Iben, CFA
Chief Investment Officer
Tradewinds Global Investors
September 2010

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