The Art of Intelligent Investing℠

August 8, 2011

I am writing this memo to update you in the midst of the last few weeks of volatile markets and following the announcement last Friday evening (after markets closed) that S&P had decided to downgrade the U.S. sovereign credit rating from AAA to AA+, as well as, assign a negative watch to this revised credit rating. This unusual step by S&P was not followed (as of yet) by the other two major credit ratings (Moody's and Fitch - my guess is that it probably won't be - at least for now - as they wait and gauge the reaction to S&P) and has already generated a tremendous amount of debate, discussion, and some fear as well. Given that markets were already nervous - primarily about weaker U.S. economic data and slower than expected U.S. economic growth - and correspondingly have declined substantially over the last few weeks, it is quite possible that this news may add further to market volatility in the near term. At the least, however, the selling has been extremely one-sided leading to a condition professionals refer to as "oversold". In the past, such periods have often been followed by a significant bounce.

In this letter I would like to discuss and give you some context regarding this downgrade, as well as, what you may have been reading about over the last few weeks and share with you some perspectives on these headlines and their investment implications as well. Regarding the downgrade itself, S&P has courageously stuck its neck out by issuing this downgrade. Technically, a triple AAA rating is assigned to issuers (which can be governments or companies) to only the highest quality of borrowers with the lowest credit risk -- Issuers for whom there is little doubt as to their ability to repay both interest and principal.

In issuing this downgrade, S&P also issued a detailed report as to their rationale of this action. To quote S&P:

> "We lowered our long-term rating on the U.S. because we believe that the prolonged controversy over raising the statutory debt ceiling and the related fiscal policy debate indicate that further near-term progress containing the growth in public spending, especially on entitlements, or on reaching an agreement on raising revenues is less likely than we previously assumed and will remain a contentious and fitful process. We also believe that the fiscal consolidation plan that Congress and the Administration agreed to this week falls short of the amount that we believe is necessary to stabilize the general government debt burden by the middle of the decade.
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> Our lowering of the rating was prompted by our view on the rising public

> debt burden and our perception of greater policy-making uncertainty, consistent with our criteria ….. Nevertheless, we view the U.S. federal government's other economic, external, and monetary credit attributes, which form the basis for the sovereign rating, as broadly unchanged."

This news shouldn't (and didn't) come as much of a surprise to most investors. In April 2011, S&P telescoped the possibility of a coming downgrade to the U.S. sovereign ratings, and Friday's downgrade simply continues to back up the path that S&P already laid out. When a rating agency places an issuer on negative watch, as it did with the U.S. rating in April, such a move often foreshadows an official downgrade. Nevertheless, markets reacted today, and possibly the remainder of this week -- though it is likely that this news has already been largely factored into securities prices.

Based on the report issued with the downgrade, S&P's main rationale seems to be that the recent deal in Washington was inadequate as to the magnitude of cuts and/or revenue affected (especially when it comes to out-of-control entitlement spending) and, therefore, won't really solve the accumulating debts to a sufficient enough degree. S&P's reasoning is not faulty and could even serve as a positive factor if it helps some in Washington become more serious about addressing the long-term challenge of our ballooning debt and deficits with more urgency than they have shown to date. Clearly, the trajectory of U.S. debt and deficits is not sustainable and will have to change -- either in advance or by force when all other options are exhausted.

Bond markets, which tend to pay attention to these things, however, have been signaling the opposite of what you would expect in a country whose rating has been, or is about to be, downgraded. Indeed the bond market has seemingly been ignoring the rating agencies and the growing debt and deficits for some time.

The best measure of this contradiction is the U.S. long-term treasury bonds -- such as the 10-year treasury bond which, in the weeks leading up to the debt ceiling showdown on August 2 and through today, has rallied and dropped interest rates to extremely low levels (less than 2.4% per year for 10 years, as of today). In effect, the bond market has been signaling that as far as investors are concerned, the U.S. treasury bonds remain as much of a safe haven (and essentially triple AAA) as it ever has been. Otherwise, why would so many investors tie up so much money for 10 years at an interest rate that might just barely stay ahead of inflation (if not provide a negative real - i.e. after inflation-return)? Investors still view the treasury bond as one of their preferred safe havens.

Despite the S&P Rating change on Friday, most would agree there is still no doubt about the ability of the U.S. Government to pay its debts (and the post downgrade rating still remains extremely high). At least in nominal (dollar) terms, any interest and principal payments due can always be made because these debts are denominated in U.S. dollars -- which are issued by the Federal Reserve Bank. Ignoring S&P, investors have been voting with their feet (and cash) and proclaiming that they have no concern nor any doubt that they will get back their principal and interest on loans that they are still making to the U.S. (at shockingly low rates).

It's unlikely that the S&P ratings change will affect (except marginally) this willingness by investors to lend money to the U.S. at near all-time low rates. Therefore, we think that from a practical point of view, the rating downgrade has little lasting effect -- though it does signal a shift that will affect investor psychology. Even this effect is unlikely to be lasting, as there are many countries without a AAA rating that function perfectly well and have growing economies. Indeed, the Chinese sovereign rating was BBB+ in 1997 and upgraded over a period of years to A+ only in July, 2008. India, another "hot" economy has a sovereign credit rating of BBB- which is also the same rating as Brazil. Unlike for the U.S., these ratings actually affect the cost of borrowing by these countries, but a rating, in and of itself, is no impediment to economic progress and U.S. borrowing rates still remain among the very lowest in the world.

Irrespective of the downgrade, however, long-term issues do remain. These long-term issues include the following:

- Due to Washington's gridlock and dysfunction, the U.S. remains on an unsustainable fiscal trajectory -- and this trajectory will have to change

- Certain European countries (such as Greece, Portugal, Ireland, Italy and Spain) are in far worse shape than the U.S. because their debts are denominated in a currency (the Euro) that they don't control and can't print. However, other European countries are supporting their obligations, though these obligations need to eventually be restructured

- Japan has (by far) a greater amount of debt than the U.S. does (relative to GDP) and is on an even more unsustainable path

- There is an ongoing battle between the forces of inflation and deflation (for now, both seem to be evenly matched and it's not clear which force will win out in the intermediate term). However, the need to cut back on the debts and deficits means that deleveraging will be required and this is more deflationary in the short-term. To the extent that governments' central banks respond by printing money, it can eventually be inflationary (a reason, along with technical buying, why gold keeps rising)

- Unemployment in the U.S. is still too high -- though the overall number is masking some underlying and important progress -- the private sector has been hiring at a moderate pace but these gains have been offset by governments, especially at the state and local levels, being forced by fiscal constraints to cut back.

When markets react as they did the last couple of weeks, and again today, we should try to remember they can and do often swing violently based on investor psychology. This is especially true in recent years because there seems to be a surplus of traders (rather than investors) who look at the world (and their portfolios) based on a binary (i.e. black or white/risk-on or risk-off) point of view. Because they try to time markets in the short-term, they follow momentum and get in and out of markets (value is considered either irrelevant or an afterthought) sometimes multiple times per week. As a result, they have a tendency to excessively magnify any news with herding type behavior -- news that would otherwise justify a 5% decline can quickly become 10% or 15%. Though their approach has largely been discredited in the only place that ultimately matters (i.e. their pocketbooks), they nevertheless continue to incur the inefficiencies that go along with their approach.

To this large group, at any given point in time, the glass is either half empty or half full. Whenever these investors (using the word loosely) feel pessimistic or get some piece of bad news, they see the glass as half empty. The financial media also encourage this approach by featuring "experts" who are bearish or can offer an appealing sound byte to explain the day's market action. Trading strategies, safe havens, moving averages, and recessions are often invoked glibly. Correspondingly, when they feel optimistic, they focus on the half full and act accordingly. What leads to so much volatility in markets is that so many investors have a tendency to swing violently and rapidly from one view to the other.

Of course if you choose to watch this ping-pong activity and coverage with anything less than amusement and skepticism, you are likely to experience a rising sense of panic each time the market falls -- watching seems to reinforce the notion that everyone else got the memo (that you somehow didn't) and they are all watching contentedly from the sidelines while you suffer. However, there are very few reminders of the actual fact that these predictions and fears often turn out to be wrong or too much after the fact to actually be useful or actionable. The wisest advice on these swings comes from Warren Buffett whose advice was to "be fearful while the world is greedy and greedy while the world is fearful."

In reality, the world is much more complex than any of these simplistic reactions -- economically, most of the time, the glass is both half full and half empty at the same time. We certainly think that to be the case right now. The mood swing of these "investors" and the back-and-forth swings of markets tell us more about the investors than they tell us about the future of markets.

What is lost in all this back and forth is any perspective or principled approach. The reason to keep perspective and stick to proven principles is that they work (but take time to do so).

Keeping Perspective

On the heels of the August 2 budget shenanigans in Washington DC (which was eventually resolved as we expected -- with a compromise around the debt ceiling and one more kick of the proverbial can down the road), and this most recent headline around the ratings downgrade, investors are not focusing on some positive facts that would (and probably will) counterbalance their new pessimism:

- We are in the third year of a recovery from the depths of the financial crisis (and the recovery in the real economy -- while slow -- is at least likely to muddle along into the back half of 2011 and into 2012). Evidence points to this recovery continuing (and not to another recession). Even if there were to be another recession, it would be temporary and end by 2012 (in all likelihood)

- The notion of a slowly recovering economy is supported by good corporate earnings which have generally been decent in 2011 after good progress in 2010

- Corporate balance sheets are very strong (though government balance sheets are under pressure) and equities represent ownership in these same companies that hold substantial amounts of cash and assets, are profitable, and conservatively financed. Dividend paying companies are particularly attractive

- Just in the last two years of a recovering market, there have been a number of these sharp corrections -- no recovery proceeds only upwards -- we can and should anticipate drops and pessimism even during the above general trend of improvement. Moreover, while the drops have been quick and accompanied by a spike in pessimism each time -- so far the market has bounced back each time as illustrated below:

    - Last summer, from April 26, 2010 (Dow: 11,205.03) to July 2, 2010 (Dow: 9,686), the Dow declined 13.6%. By February of 2011 however, the market rose past 12,000.

    - Earlier this year, from February 29, 2011 (Down 12,391.25) to March 16, 2011 (Dow: 11,613.30), the Dow declined 6.3%. Within 15 trading days, the market was over 12,400 again

    - Then from April 29, 2011 (Dow: 12810.54) to June 10, 2011 (11,951.91) the Dow declined 6.7%. By mid July 2011, the market peaked at 12,724

- Compared to bonds (which are seemingly very overvalued and yield close to nothing), ownership of companies is relatively attractive. While this comes with the volatility of markets -- most of you should ignore this volatility as it will be irrelevant to your results in the long-term (unless you take advantage of buying when things are cheap, in which case declines could actually benefit you). Since we often carry cash in our accounts, it is likely to be a net benefit to you in the long-term

- Our focus on value investments and conservative positioning in high quality/short-term bonds should serve us well by providing an additional line of defense. Value is ultimately a good defense against losing money permanently, though when it comes to volatility you'll still be affected in the interim

- As a Ridgewood Investments client, we've also positioned your portfolio, after a discussion with you, regarding your desired level of risk and time horizon. For most of you, there is a mix of equities and bonds (the latter to dampen overall portfolio volatility and add liquidity). Also, we generally own companies that are both good and cheap. Right now, they may be getting cheaper, and its not fun, but they will likely recover.

The Stock Market Crash of 1987

A case study that I lived through ties together many of the above points in a powerful way. I vividly remember the stock market crash of 1987 (which occurred over 23 years ago). On Monday, October 19, 1987, the Dow Jones Industrial Average dropped 508 points (almost 23%) in a single day from Dow: 2247 to Dow: 1739 at the close. At the same time, international markets also fell by as much or more. Hong Kong fell 45%, Australia fell 42%, the UK fell 26% and so on. Subsequent to that event, and a few years later, the U.S. encountered the Gulf War and a severe economic contraction in 1990-1991, as well as, a stagnant/declining real estate market through the mid-1990s.

While the crash and the economy was a big deal and caused a lot of commentating and worry, the Dow since that event rose from 1739 to around 11,000, as of today. This happened without the reinvestment of dividends which (if included) gave you a gain since the crash of about 8.5 times your money. For all the sound and fury, long-term investors did quite well (and this example can be repeated with any other similar period of pessimism and should be applicable to our current circumstances, as well). Assuming very conservative rates of compounding, we can predict that within 10 to 12 years, the Dow will probably rise above 20,000. Our value oriented strategies should be able to do even better. When you think of the 20,000, which is almost certain to come, the current volatility seems more bearable.

For those of you with cash in your accounts (or the ability to add cash), we do anticipate that this current decline will provide us with an attractive opportunity to buy and we are preparing to do so opportunistically -- though markets are likely to remain volatile for the time being and we can't time the bottom except in hindsight.

This week, on Thursday, August 11th, I am participating with Noah Rosenfarb, CPA in a previously scheduled webinar sponsored by Money Matters NJ and the NJ Society of CPAs which is entitled "How to Invest Like Warren Buffett." To register for free, go to moneymattersnj.com and look for the Webinar registration on the home page or follow this link:

Webinar: How to Invest Like Warren Buffett
Time: August 11, 2011 between 12pm and 1pm EST
https://www1.gotomeeting.com/register/676975320

Our presentation will be introducing participants to Warren Buffett's philosophies and approach and will probably include some Q&A and commentary on applying these time-tested principles in current markets.

Finally, while we have seen a number of comments and articles written on all the issues and topics we've touched on above, a recent investment commentary from Morningstar struck us as particularly succinct and supplemental to our perspectives shared with you above. As a result, we have included a short summary quote of that piece from Morningstar in an appendix to this letter.

If reading the headlines is making you nervous and you can't sleep at night, it may make sense to revisit your allocations. However, being reactionary and short-term focused is not a path to success. So, a better option is to ignore the volatility and understand that any dips that occur are almost certainly only temporary. Still, sleeping well at night is even more important and if you need guidance or want to adjust your mix, we are ready to assist you.

As always, we welcome your questions or invite you to call or contact us if you need any input or guidance at any time.

Warm regards,

Kaushal

Kaushal "Ken" Majmudar

Appendix A
Excerpt from: "Our Take on the S&P Downgrade"
by Jeffrey Ptak, CFA of Morningstar

As you've no doubt noticed, the global equity market has declined sharply in recent days. From July 22 through August 5, the S&P 500 Index of U.S. stocks has tumbled 10.8%. Losses have been even deeper among foreign and small-company stocks, as the MSCI EAFE Index of foreign-developed equities has fallen 11.8% over that span while the small-cap Russell 2000 Index is down 15.1%.

While declines of this magnitude are hardly unprecedented, we realize that they can be unsettling and lead some to second-guess their investment decisions. We're also aware that Standard & Poor's recent downgrade of long-term U.S. sovereign debt from AAA to AA+ could give some investors pause.

In light of this, we have prepared the following commentary that summarizes our views on these events.

Summary

Generally speaking, we do not believe that recent events have made cash and bonds more fundamentally attractive than stocks. In fact, the recent equity-market sell-off has made stock valuations even more inviting, further piquing our interest. Thus, we're in the process of adjusting our diversified portfolios to shift some assets from bonds to stocks.

To quickly summarize our views:

- While there are serious issues facing global markets, including the slow pace of economic growth and sovereign-debt risks, we do not see the recent sell-off as a replay of the 2008 financial crisis.

- The downgrade of U.S. sovereign debt could cause short-term upheaval in markets and reduce the value of "risk" assets like stocks (if it hasn't already); we do not, however, believe it dramatically alters the fundamentals of various types of assets, or the way we'd assess their attractiveness.

- Stocks look reasonably priced, at worst. Blue-chips, in particular, look inexpensive.

- We believe the bond market is overbought, especially U.S. Treasuries. We are moving to further underweight bonds in our diversified strategies.

- With yields plumbing the depths, we think it is highly unlikely that inflation-adjusted (i.e., "real") bond returns will top stocks over a 5- to 10-year time horizon.