Tips for Our Potential Clients

Before we get to the meat of the investment note we want to mention one thing first. Since the world is full of experts that you can find on CNBC, Fox News, Bloomberg, Wall Street, Ivy League Universities and politicians, the potential client has a vast array of advice at his disposal that can make him or her financially secure, right? We will let you decide that but we wanted to give you a few tips that we have found useful in trying to decrypt the news streams that are floating all over the place. We would advise you to be skeptical of everyone and everything when it comes to your money—that includes us. Everyone you see or hear from has different incentives to tell you what to buy or sell. CNBC has a very optimistic viewpoint about where markets are headed because if they do not then advertisers (financial institutions) who buy commercial time (and place their analysts on their show to be interviewed) will not spend ad dollars. The analysts on the shows are helping their banks to sell mutual funds and other investment products for which they will receive a future bonus or commission from. Politicians will undoubtedly promise you the moon and stars to get re-elected. CEOs of publicly traded companies will most likely not talk about their companies in a negative light when part of their compensation depends on stock options and a higher stock price. Consequently, we hope you remain cognizant of these incentives in choosing where and with whom to place your money.

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Are We Approaching An Epic Failure?

Source: www.motivatedphotos.com

Americans love great stories. In fact, they are downright infatuated with them. This shouldn't come as a surprise to anyone since the art of storytelling has been embedded into the DNA of this country from day one of the American Revolution when our Founding Fathers decided that being governed without representation was no longer tolerable. Over the last 235 years, this country has had the blessing of being able to add to its repository of remarkable stories with the influx of immigrants from around the world that brought along with them their knowledge and cultures to this melting pot, creating an eclectic amalgamation that adopted the best attributes of each culture, while slowly discarding anything superfluous. In flowed new ideas, technological breakthroughs and resilience and out went ignorance, racism and lack of respect for the fellow man. The stories that we wrote in this country were so inspiring, that we even exported them to the rest of the world with the advent of Hollywood, but now it looks like a different type of story is being written. It has become a horror film that has us on a journey toward a metaphorical, abject town named Epic Fail.

Hollywood wishes that they could write a script as frightening as the one for Epic Fail. Art often imitates life, but why any artist would want to imitate this story is beyond me. This is a story of the next chapter of the United States. It is filled with politicians that are reliably-unreliable in the face of a gigantic tsunami of global sovereign debt (and BP oil), financial crony capitalism ("We don't break laws because we pay our lobbyists to make them!"), baby boomers retiring en masse to encounter a Social Security-Medicare-Medicaid-ponzi scheme, geopolitical strife with Iran and North Korea, a China real estate bubble, global food and energy shortages and much more. Heck, there's even an Icelandic volcano to boot!

While our good buddy Helicopter Ben[1] needs to find out that there's more to life than printing <u>really, really, really</u> ridiculous amounts of money, at least he's providing us with the parchment on which the citizens of the United States (and the world) can finish writing this story. I'm not sure how this collective story is going to end, but let's take a look at the obstacles we'll be facing and how we can prepare for them so we

[1] Ben Bernanke is the Chairman of the US Federal Reserve. Ben was given this nickname after he referred to a statement about using a helicopter to drop printed money into the economy.

don't end up in a situation where we get caught between a rock and a hard place . . . or in this case a Mayan calendar and 2012.

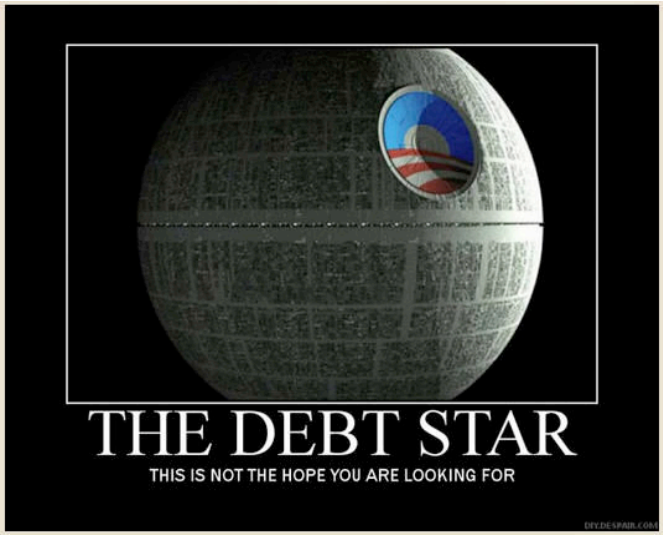
Items on Our Radar

Regrettably, the typical investment path cannot be mapped out in Google Maps. We can't ever know all of the total events that lay between you and your financial goal(s), but we do know that a contrarian, value investment philosophy that focuses on capital appreciation while garnering additional income can be a compass toward achieving respectable returns. While the number of outstanding risks are too numerous to be counted, listed below is a sample of what we believe are material areas that pose risks to your sanity, health and financial portfolio.

1. Sovereign Debt Crisis – European PIIGS, UK, Japan and the USA
2. USA Crony Capitalism and a Political Re-Awakening
3. States and Municipal Budget Shortfalls: Swimming in Oceans of Debt
4. Baby Boomers: Will Golden Years Be Golden?
5. Elephant in the Room: The Commercial Real Estate Debt Bubble
6. Peak Oil: Even the Rappers Get It
7. China: The Great Imbalance
8. Other Blips On Our Radar
9. What We're About

While at first glance, it appears that these situations are all mutually exclusive of each other, we want to remind our investors and readers that life cannot be simplified into grocery lists. These situations are inter-related within one large connected system and the outcome of one will undoubtedly have consequences on others.

1. Sovereign Debt Crisis – European PIIGS, UK, Japan and the USA



Source: diy.despair.com

Global Debt: Here's the scoop on what we face.

Subsequent to the financial collapse that began in 2007, and appears to have ended in 2009, a new crisis has emerged in Europe (PIIGS – Portugal, Ireland, Italy, Greece and Spain) and the UK, and with high probability, will eventually surface in Japan and the USA. It is a sovereign **debt** crisis, and I emphasize the word debt because all of the remedies that are being proposed are just beginning to address the main cause of this predicament.

Debt originates from the same root cause, despite the differences in the cultures of the affected countries, and this cause is spending at a higher rate than revenues, and making up the shortfall with borrowing. Eventually unchecked growth in debt, whether at an individual, corporate or sovereign level approaches a tipping point, called a Minsky moment, where the employment of debt is no longer justified by the benefits it provides. A good analogy to this is a personal credit card. If you keep on borrowing, eventually you will reach a point where the monthly payment will be so large and will grow so quickly that you cannot afford to pay down the debt anymore resulting in default. Many of the countries in the charts below are now close to, if not already in this situation. **To solve a debt problem, spending must be reduced, revenues increased and the surplus savings must be used to pay down debt.** If Captain Obvious talked about this he would say, "Paying down debt is no fun." It takes a long time and sacrifices must be made, but reality is what it is. We've shown several countries' gross debt as a percentage of GDP to give you an idea where each country stands. The IMF recommended target level for debt as a percentage of GDP is 60%. The graphs show we are well past that.

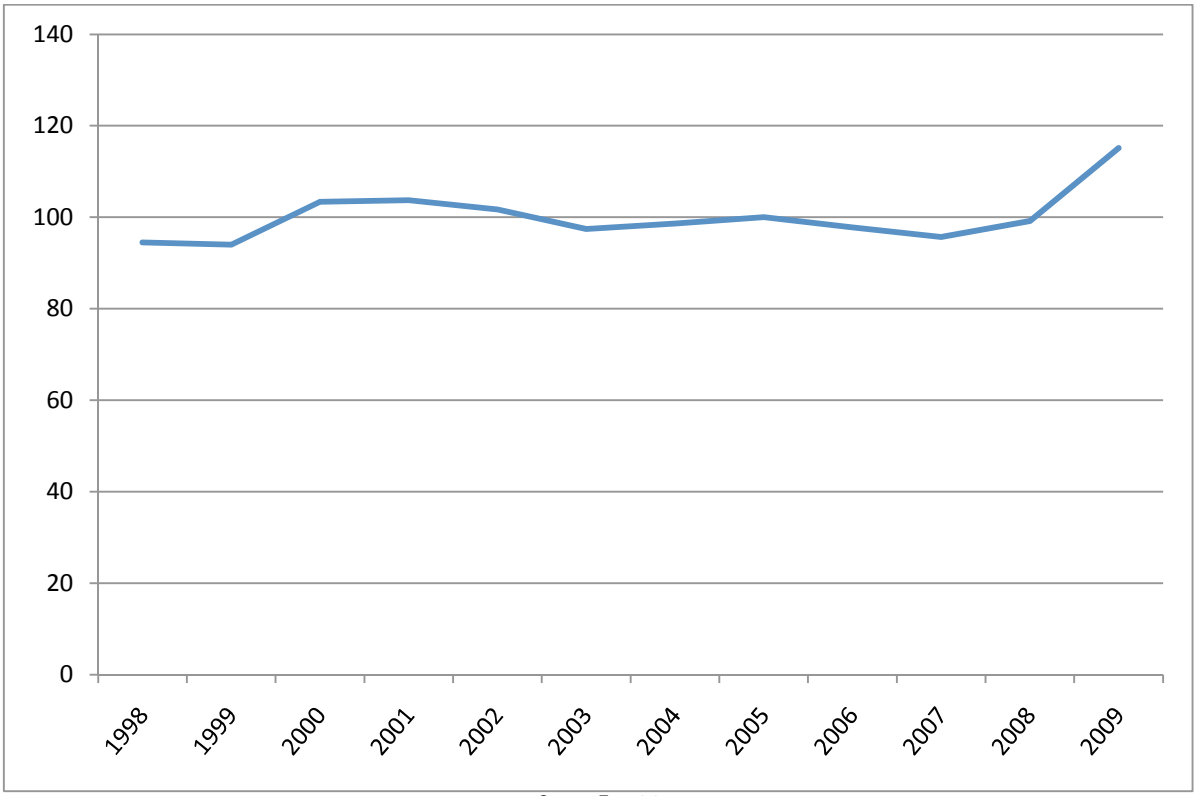
Advanced Economies' Gross Financing Needs, 2010

(in percent of GDP, unless otherwise specified)

	Maturing Debt	Deficit	Gross Financing Needs	Gross Debt (2009)	Average Maturity (years)
Australia	2.0	-5.0	7.0	15.5	4.8
Belgium	20.8	-5.1	25.9	97.3	5.4
Canada	15.9	-5.3	21.2	82.5	5.6
France	16.9	-8.2	25.1	77.4	6.5
Germany	10.2	-5.7	15.9	72.5	6.0
Greece	13.4	-8.1	21.5	115.1	7.4
Ireland	7.7	-12.2	19.9	64.5	6.7
Italy	21.2	-5.2	26.4	115.8	6.7
Japan	54.2	-9.8	64.0	217.7	5.2
Portugal	13.0	-8.8	21.8	77.1	6.2
Spain	10.3	-10.4	20.7	55.2	6.7
Sweden	6.8	-3.3	10.1	40.9	6.0
United Kingdom	8.6	-11.4	20.0	68.2	12.8
United States	21.2	-11.0	32.2	83.2	4.4

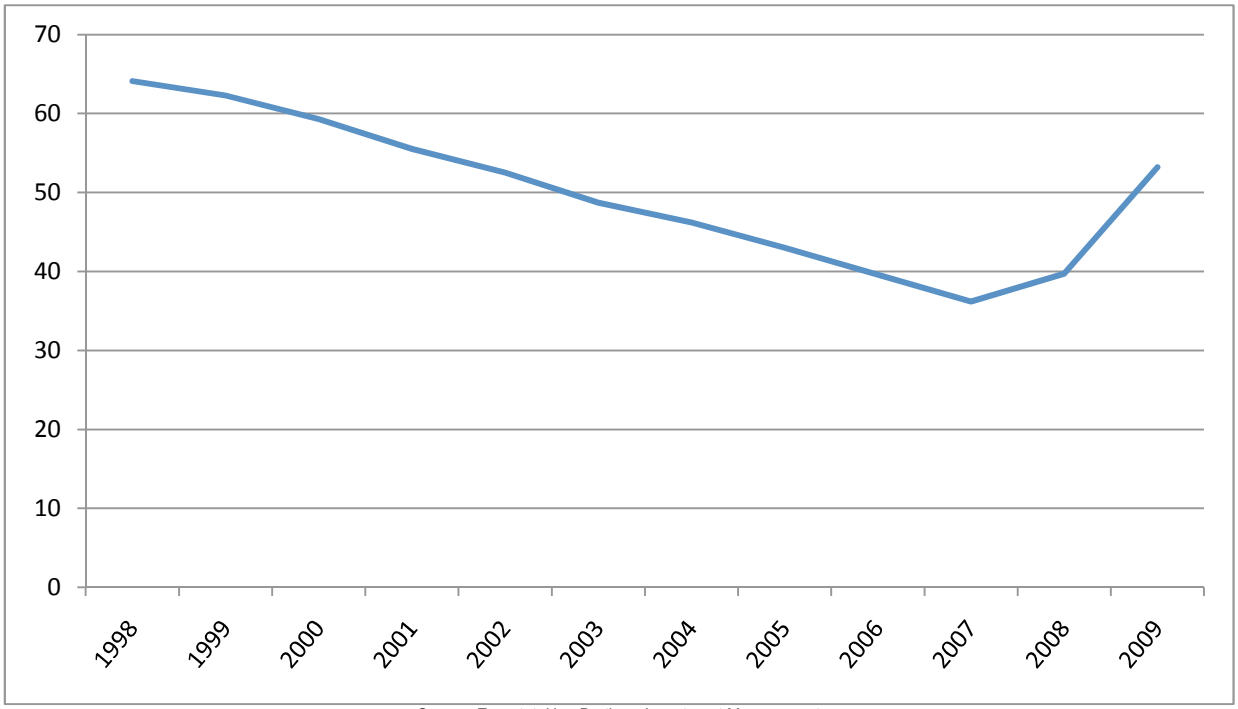
Source: IMF Fiscal Monitor May 2010; IMF April 2010 WEO for deficit and debt; Bloomberg and IMF staff estimates for maturing debt and average maturities

Greece General Government Consolidated Gross Debt as a Percentage of GDP
(in percent of GDP)



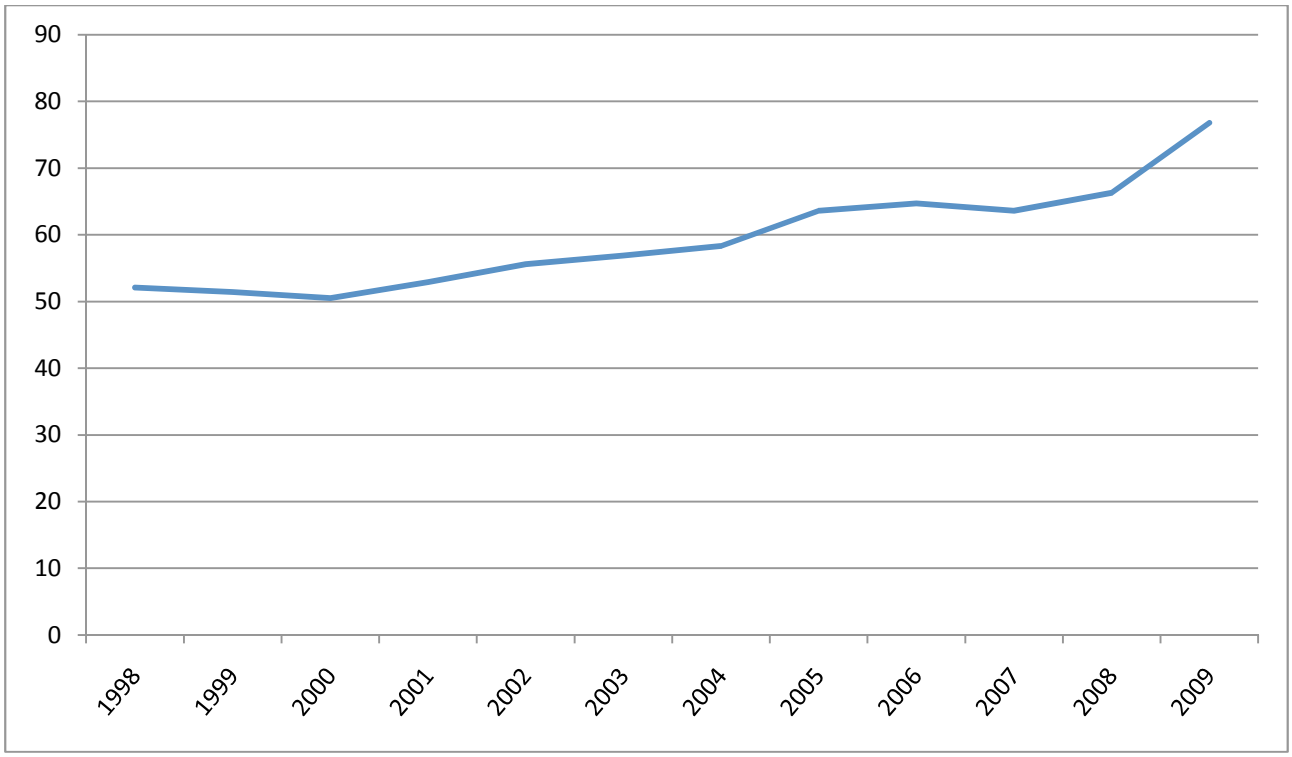
Source: Eurostat

Spain General Government Consolidated Gross Debt as a Percentage of GDP
(in percent of GDP)



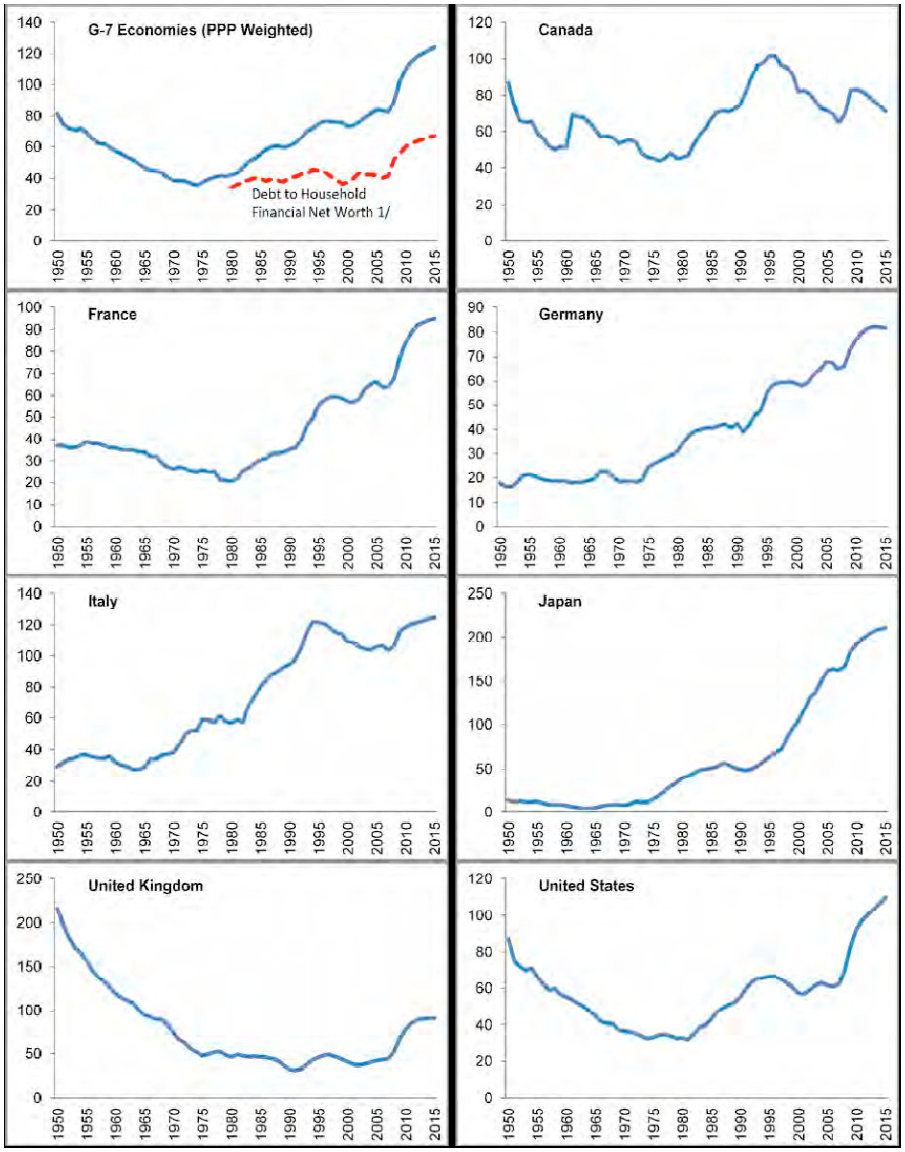
Source: Eurostat, Hoe Brothers Investment Management

Portugal General Government Consolidated Gross Debt as a Percentage of GDP
(in percent of GDP)



Source: Eurostat, Hoe Brothers Investment Management

General Government Gross Debt in G-7 Economies, 1950-2015
(In percent of GDP)



Sources: IMF World Economic and Financial Surveys May 2010. Government debt database of the IMF's Fiscal Affairs Department. Data refer to the general government, except for Japan (central government).They are drawn mainly from the IMF's WEO database (2010–15 are projections), supplemented by the following: *Canada (1950-60) - Federal Gross Government Debt (Haver* Analytics); *France (1950–77) - National Debt (Goodhart, 2002); Germany (1950–75) – Credit Market Debt* and Loans (Statistisches Bundesamt Deutschland); *Italy (1950–78) - National Government Debt (*Banca d'Italia); *Japan – Central Government Debt (Ministry of Finance of Japan)* until 2009; subsequently, WEO projections for changes in the debt ratio; *United Kingdom (1950–79)* - National Debt (Goodhart, 1999); *United States - Gross Federal Debt (Office of Management and Budget;* and U.S. Census Bureau). 1/ Ratio of gross debt to household financial net worth for Canada, France, Italy, Japan, and the United States.

The graphs illustrate that a significant portion of the developed world is mired in debt and that severe measures must be taken to rectify this situation. Politicians around the spectrum have proposed different measures on how to address this situation, but each antidote to the debt problem is insufficient by itself. Trade restrictions, stock market circuit breakers, and new regulatory legislation are some of the proposed remedies that do not solve this problem. Bailouts and stimulus packages no longer work effectively since they add to the debt burden while marginally increasing growth in the short term. This only gives the sovereign debt addict his temporary high until the effects of stimulus wear off and more debt needs to be applied to get a bigger kick. Part of the solution is to reduce spending, but most politicians do not have

the means or gumption to cut social programs in a bid to reduce debt and those that do will have to deal with pensioners and union workers that depend on free medical care and social benefits to sustain themselves. These unions and select members of the electorate are opposed to the elimination of benefits that they are accustomed to for survival and the decision to reduce these benefits are difficult ones to make, especially when the removal of benefits often results in violent public riots like Greece recently experienced.

How Global Debt Affects You!

So what options are available to governments that want to solve its debt burden? They can do several things, all of which will directly affect you (pay attention!):

a) Raise taxes. This one is self-explanatory. I don't think anyone enjoys having Uncle Sam reaching into your pockets to get more of your hard-earned dough. We can expect newly implemented and higher taxes in the future. The Bush tax cuts are set to reset in 2011 to their prior higher levels.
b) Lower spending. Social Security, Medicare and Medicaid are not the only targets, but most likely will be affected in the future. Lower defense spending will need to occur. Also education will likely be targeted first as politicians move up the food chain targeting programs whose supporters' ire will not be able to threaten their re-election.
c) Print money. While you will no longer hear it referred to as printing money these days, this approach goes by the euphemisms "quantitative easing" or "monetization of debt." This is essentially a country imposing a hidden tax on the citizens of a country. Here's a very simplified example that hopefully explains what the Federal Reserve Bank wants to do to investors who are ill-prepared.

   Example: Imagine you live on an island with ten pineapples and on your island the total money supply is $10.00. If we "priced" the pineapples, each one would have a hypothetical cost of $1.00 per pineapple. Now suppose Mr. Bernanke was the central banker of your island and printed an additional $10.00 which ended up in your money supply. The number of pineapples on the island is still ten, but now you have $20.00 total in your money supply. The new cost per pineapple is now $2.00. This increase in the price level is defined as inflation, where Yogi Berra aptly noted, "A nickel ain't worth a dime anymore." The number of pineapples remains unchanged but money supply has increased. This harms the savers and citizens of a country. Suppose I live on this island but I only have $6.00 in my wallet. Pre-Bernanke I could purchase six coconuts but post-Bernanke I can only afford three. Bernanke took $3.00 of purchasing power away from me (this is a hidden tax)!

   How do I protect myself from Bernanke's actions? Buy the "coconuts" before he prints the money.

How the Global Debt Situation is Likely to Play Out.

We believe that governments around the world will elect a combination of all three options to reduce government debt. Higher taxes and lower spending through austerity measures are almost guaranteed in the sovereign nations globally. But where option-C applies becomes a little more complicated.

In the European Union (EU), the option to print money does not exist at the individual country level because this responsibility is held at the EU level. The European Central Bank (ECB) can print more Euros if it desires, but individual members such as Greece, Spain and Portugal cannot. The ECB is reticent to engage in quantitative easing due to opposing cultural differences between member countries. Germany, which prefers monetary stability as a result of the hyperinflationary Weimar incident in the early 1920s opposes quantitative easing, whereas smaller countries encourage it. As it is, these opposing interests leave the ECB in a deadlock over the monetization of debt and additional bailouts, and unless the individual members leave the EU (which is difficult to do), option-C is not a viable option. Thus the politicians are ensconced with the responsibility to make the tough decisions to impose austerity measures and raise taxes on a populace that has been accustomed to receiving generous government benefits. Reducing these benefits will be difficult as the populace will not give these benefits up without a fight. We saw the violent riots in Greece and we can expect further civil unrest in the future as citizens and governments fight over benefits.

The United Kingdom, Japan and the United States are grouped into a second category of countries that Nobel winning economists such as Joseph Stiglitz and Paul Krugman like to point out, have access to the almighty printing press. This group of economists (along with other notable professionals) argues that the UK, Japan and US will not default because they can print money to pay off their existing debt. Now I know that concept might be a little confusing to you at first. You might be sitting there scratching your head thinking, “Wait a minute . . . I can buy something on my ‘credit card’ and then pay it off with money I’ve printed from my computer using Photoshop?” Sorry buddy. You can’t do that. You go to jail for counterfeiting. But if Uncle Sam does it, it’s legal. The argument of always being able to print does not hold water. If you refer to the charts above you can see that the debt burdens in the UK, Japan and US are sizable sums and to top it off the maturities are near term for those in the United States. This means the government would have to print enormous amounts of money in short order to purchase the debt that would be maturing. Remember our pineapple example? Well imagine that in hyper-drive and you end up with a currency that is for all intents and purposes debased, devalued, destroyed, or whatever you want to title it. Soon on the “island” of the United States, it might take $5.00-$10.00 to buy a pineapple and $10.00-$20.00 for a gallon of gasoline, figuratively speaking. To protect yourself in our example on the island you would buy the coconuts before this printing occurs. In reality, you would protect yourself by purchasing tangible assets. Tangible goods like certain commodities (gold, silver, or oil), cash flow producing real estate or the stocks of blue chip companies with strong balance sheets and inflation resistant earnings power selling at a discount to intrinsic value. Bonds are not favored for multiple reasons, but the significant ones follow: First, borrowers will be paying you back in dollars that are effectively worth less due to inflation. Second, most government borrowers – municipalities, states or Federal government – are broke and may not be able to repay you. Third, when you have a situation where governments are riskier borrowers in total, interest rates usually rise to compensate for this risk. Bond prices and interest rates are inversely related. As interest rates climb to reflect this risk, bond prices will fall. Accordingly, this is the reason we do not recommend fixed income bonds (despite Wall Street’s recommendations for allocating funds toward municipal bonds and bond mutual funds right now).

The sovereign debt crisis is only getting started and we don’t expect the denouement for some time in the future. Volatility, large currency swings and heavy government interference are all expected.

2. USA Crony Capitalism and a Political Re-Awakening

The laws in this country are rigged. No, not rigged like a “coincidental NBA finals playoff series going to game seven between the Lakers and Celtics” rigged. But rigged in an “I am not breaking the law because I paid lobbyists to change it to suit me” kind of way. K Street, headquarters of Washington lobbyists often spend their time with politicians who are reliably-unreliable. Politicians whose gift for gab usually serves

as a perfect negative indicator for competence (note to self: red flags should go up with a smooth talker). We cannot completely blame the politicians for continually disappointing us though. More often than not, the barometer that we employ when deciding if we can elect a politician is the "beer test." Can we see ourselves spending time with this guy or gal chatting it up over a cold one?

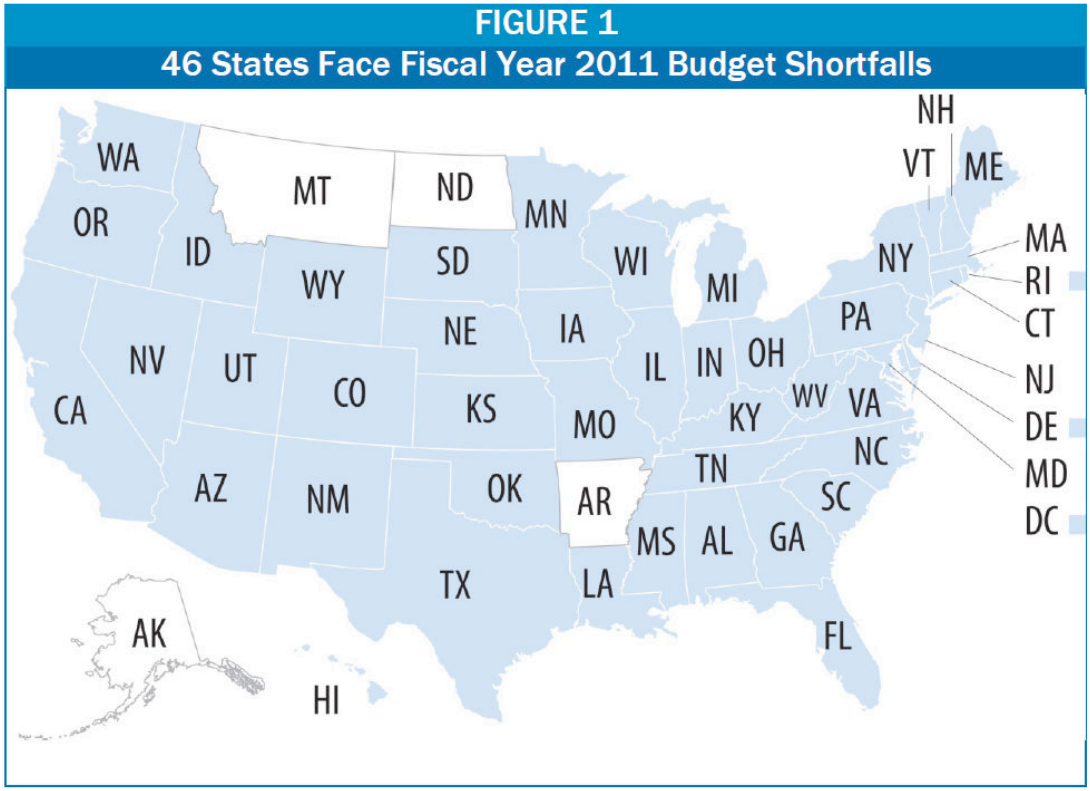
Can we elect him? He's holding a beer! YES, WE CAN!!

The metric we should really be using is does this candidate have a titanium laced backbone the size of a blue whale, does he or she wield a big stick and can they protect liberty and the integrity of the Constitution and promote the interests of its citizens against vested interests. Can we trust them? Will they tell us the truth instead of sweeping it under the rug? The answer has been resoundingly mixed. In addition to having a President who in Old Macdonald children's song style put a "Czar-Czar" here and a "Czar-Czar" there (we have twenty-eight appointed czars now, the most recent being the oil czar), Americans are disappointed to find out that Congress and the President green-lighted several stimulus measures that didn't serve to stimulate anything except for pork-barrel projects and handouts to various industries. The American Recovery and Reinvestment Act that cost the citizens of the republic $787 billion, was the most prominent of the bailouts which is significant for being passed against the wishes of the American public but was also passed without any member of Congress reading the entire bill which was over 1,000 pages long. In conjunction with this, additional bailouts were implemented such as TARP, TALF, GM's bailout, Freddie Mac, Fannie Mae and other backdoor deals involving Washington Mutual, Bear Stearns, Merrill Lynch and Countrywide. The recent healthcare bill was another contentious issue that incited debate amongst the citizens of the US and a new financial regulation bill that has very few teeth is currently making its way through Congress. (How do we know that the financial regulation bill will probably be ineffective? Bank stock prices went **UP** after the terms of the potential new bill were released!)

While there have been a few dissenters, the majority of politicians have placed the interests of the K Street clan ahead of their constituents. Politicians are learning that doing this puts their job at peril. Citizens will not re-elect politicians who ignore them and this is evident in the movements to remove incumbents such as Harry Reid, Christopher Dodd, John McCain and numerous others. As a consequence of ignoring their constituents' needs, various political movements have established

themselves – most notably the Tea Party. While initially described as radical by various pundits, we view the establishment of this new political movement as an answer to the lack of acknowledgment by politicians to the needs and wants of its citizens. Citizens are now politically awakened and we expect to see a larger number of movements that will challenge the established order. We are paying particular attention to this movement since the political uncertainty that may arise might result in new laws being legislated that will seek to level the playing field between businesses and citizens.

3. States and Municipal Budget Shortfalls: Swimming in Oceans of Debt



Source: Center on Budget and Policy Priorities

States and municipalities throughout the country have been tossed into an ocean of debt, and similar to what you would see in a mobster movie, states and municipalities are being sent to Davy Jones' Locker with a pair of cement boots. Over the years, states and municipalities have managed to exacerbate their debt positions by taking on large scale projects by borrowing money (issuing bonds, both federal and municipal) during good times with the misguided expectation of repaying investors during even better times. As the economy raged on, states and municipalities were unrelenting in their desire to take on additional projects. Unfortunately for our states and municipalities, all good times must eventually end, and when they did it left states and municipalities in a situation where they were unable to repay their debt. A good example comes from an article written by Steven Malanga, taken from the Wall Street Journal:

> *Nearly 40 years ago the Garden State borrowed $302 million to begin constructing the Meadowlands. The goal was to pay off the bonds in 25 years. Although the project initially went according to plan, politicians couldn't resist continually refinancing the bonds, siphoning revenues from the complex into the state budget, and using the good*

> *credit rating of the New Jersey Sports and Exposition authority to borrow for other, unsuccessful building schemes.*
>
> *Today, the authority that runs the Meadowlands is in hock for $830 million, which it can't pay back. The state, facing its own cavernous budget deficits, has had to assume interest payments—about $100 million this year on bonds that still stretch for decades.*[2]

The state of New Jersey is not alone. According to a report from the Center on Budget and Policy Priorities, forty-eight states face a budget shortfall for the current fiscal year 2010 (which will close at the end of June) and forty-six states face a budget shortfall for fiscal year 2011.[3] Furthermore, as states continue to face budget shortfalls, borrowing will continue to increase. From the same WSJ article above, "outstanding debt has soared to $2.2 trillion today from $1.4 trillion in 2000. State and local borrowing as a percentage of the country's GDP has risen to an all-time high of 22% in 2010 from 15%, with projections that it will reach 24% by 2012."

Perhaps the most precarious state with a budget deficit is California. The state faces a $19 billion deficit in the face of massive cuts in the 2010-2011 fiscal governor's budget. This is a massive number and Sacramento still is grasping for solutions but cannot find one. California with a state unemployment rate of 12.4% in the month of May, experiences one of the higher rates in the nation with the US seasonally adjusted rate being 9.7%. The financial markets are telegraphing to us that California is at a high risk for sovereign default and accordingly is charging higher rates to insure their bonds and on June 26, 2010 relayed to us that California has a 26.99% chance of defaulting. California is the United States' canary in a putrid coal mine and a saying you will hear more of is, "as California goes, so goes the nation." California has always been a leading indicator of what the rest of the nation can expect to face with its large and diversified economy that represents roughly about a tenth of the nation's GDP.

Highest Default Probabilities
(CDS Spreads)
June 26, 2010

Entity Name	Mid Spread	CPD%*
Greece	1103.75	67.93
Venezuela	1278.05	57.97
Argentina	964.79	48.06
Pakistan	713.2	38.8
Ukraine	622.26	35.69
Iraq	480.5	29.31
Dubai/Emirate of	488.27	29.2
Illinois/State of	359.63	27.35
California/State of	**346.1**	**26.99**
Portugal	332.45	25.11

*CPD% - Cumulative Probability of Default
Source: CMA Datavision

So how will budget shortfalls affect us? If you are a teacher or civil service worker then you may already be wrestling with the fact that your job security has disappeared, and as these states continue their

[2] WSJ: America's Municipal Debt Racket; http://online.wsj.com/article/SB10001424052748704269204575270802154485456.html
[3] http://www.cbpp.org/files/9-8-08sfp.pdf

attempts at balancing their budgets we can expect to see additional layoffs of state workers. These layoffs and reductions in services will have secondary and tertiary effects on consumer businesses for the newly unemployed will not be spending on discretionary items and services (restaurants and shopping malls), and may struggle to even make their mortgage payments, adding to the still prevalent housing bust. Other things that you love to hate may be making more appearances also—graffiti, potholes and increasingly inhospitable customer service at the DMV are only a few of the many irritations that will surface with the absence of funds that grease the wheels of state and local government.

Large sacrifices need to be made for states to balance their budgets and unfortunately sacrifices are targeted for education, social programs such as health care for children and welfare for the needy. Budgetary cuts will eventually make their way up the pecking order toward government workers before more areas that can be cut are found. A significant area that will be hit are pensions. States, in their quest to balance their budgets have already begun "borrowing" from their pension funds. New York is a ludicrous example of this. New York has a pension shortfall. How did New York solve this problem? They borrowed against the pension <u>with the shortfall</u> to pay back the same pension <u>with the shortfall</u> as noted in the New York Times: "Gov. David A. Paterson and legislative leaders have tentatively agreed to allow the state and municipalities to borrow nearly $6 billion to help them make their required annual payments to the state pension fund."[4] No one has to be a rocket scientist to determine that borrowing against the fund used to pay pensioners makes absolutely no sense.

Despite the herculean tasks that states and municipalities must deal with to stay solvent, Wall Street financial service providers continue to sell products that possess fundamental flaws. The Wall Street flavors of the week that are being pitched to retail investors (the average Joe) are federal and municipal bonds, but it makes absolutely no sense to purchase these products if states and municipals are on the edge of bankruptcy. Wall Street continues to give people reasons to hate them, and this no doubt will be another one of them, and if a person had to choose between investing in municipal bonds and playing the roulette wheel in Vegas . . . always bet on black (even though this picture is showing red!).

Source: http://roulettebettinginfo.com/images/Roulette-Wheel_HR.jpg

4. Baby Boomers: Will Golden Years Be Golden?

Baby boomers are an interesting bunch of people. That's to say the least. Born between 1946 and 1964, this group of approximately 78 million was the byproduct of the post-World War II atmosphere

[4] http://www.nytimes.com/2010/06/12/nyregion/12pension.html

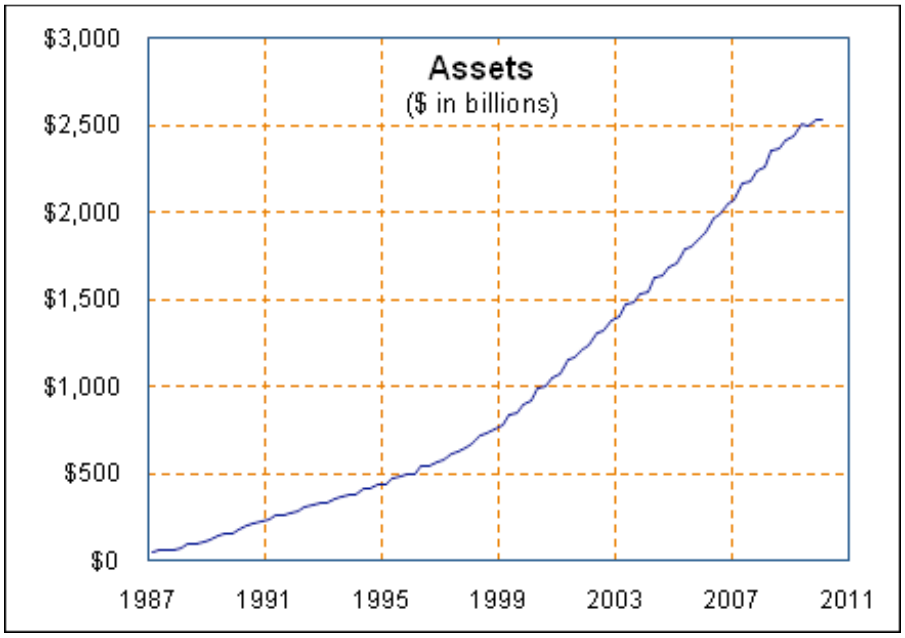
where people had a lot to celebrate with the conclusion of the war. One of the fascinating features of this generation is that they tend to think of themselves as a gifted age group that brought along with them massive amounts of positive change that restructured society into a positive force. In my humble opinion, I think they did. This group lived through memorable events such as the Civil Rights Movement, environmental movement, Woodstock, women's liberation, the Cold war, gasoline rationing and helped to push forward the technological movement in the United States. The baby boomers helped push society forward, but they did it at a cost of overconsumption. The Wall Street Journal on June 10, 2009 had an article titled, "Boomers to This Year's Grads: We are Really, Really Sorry."[5] In the article, several prominent members of the baby boomer era took to podiums at college graduations to apologize to graduating classes and to exhort them to not be like "us." Some of the graduates were a bit miffed, even saying that the boomers, "have been pretty selfish, but they're still going to be around. They need to do their part." To my WSJ attributed comrade I utter, "Economics says there's no free lunch, and the baby boomers will most likely be paying for it with some of the gold from their golden years." Baby boomers have several concerns that are at the forefront of their worries. Most baby boomers are concerned with their retirement funds which usually are derived from Social Security, savings and a 401K. They are also concerned with their healthcare, inclusive of Medicare and Medicaid.

Source: http://www.sikharchives.com/?p=2376

Remember our good friend Helicopter Ben, the central banker from our island with the pineapples? Well it turns out that he left the island and has been in charge of the Federal Reserve in the United States. This is good for the US printing industry and the woodchucks chucking wood to make the US money printing paper, but can be potentially very bad for the baby boomers. Let me explain. The majority of baby boomers will be living off of a fixed amount of income after they retire. This income will be derived from Social Security benefits (average monthly benefit payment is approximately $1,168 for old-age retired workers)[6], cash that has been saved or 401K withdrawals that most likely will adhere a required minimum distribution formula. As our golden baby boomers are trying to enjoy their twilight years, they run the very high risk that inflation will rear its head from the monetization of debt that was mentioned earlier in this report to pay down the high amounts of government debt. Seniors who are living off of a fixed amount of income that cannot keep pace with rising costs will effectively have to live with lower living standards. If we are lucky and manage to avoid an inflationary event, then we may have to deal with two other calamities that may materialize. The first is that the Federal government has borrowed $2.5 trillion against the Social Security fund and may not be able to repay the fund (without the aid of our printers).[7] As of March 2010, total assets of the Social Security Trust Fund (Old-Age, Survivors, and

[5] http://online.wsj.com/article/SB124458192890699487.html
[6] http://www.socialsecurity.gov/policy/docs/quickfacts/stat_snapshot/
[7] http://www.msnbc.msn.com/id/35865764/

Disability Insurance) totaled $2.5 trillion, which is the amount the government borrowed (refer to chart below). The government has borrowed the entire amount!



Source: www.socialsecurity.gov

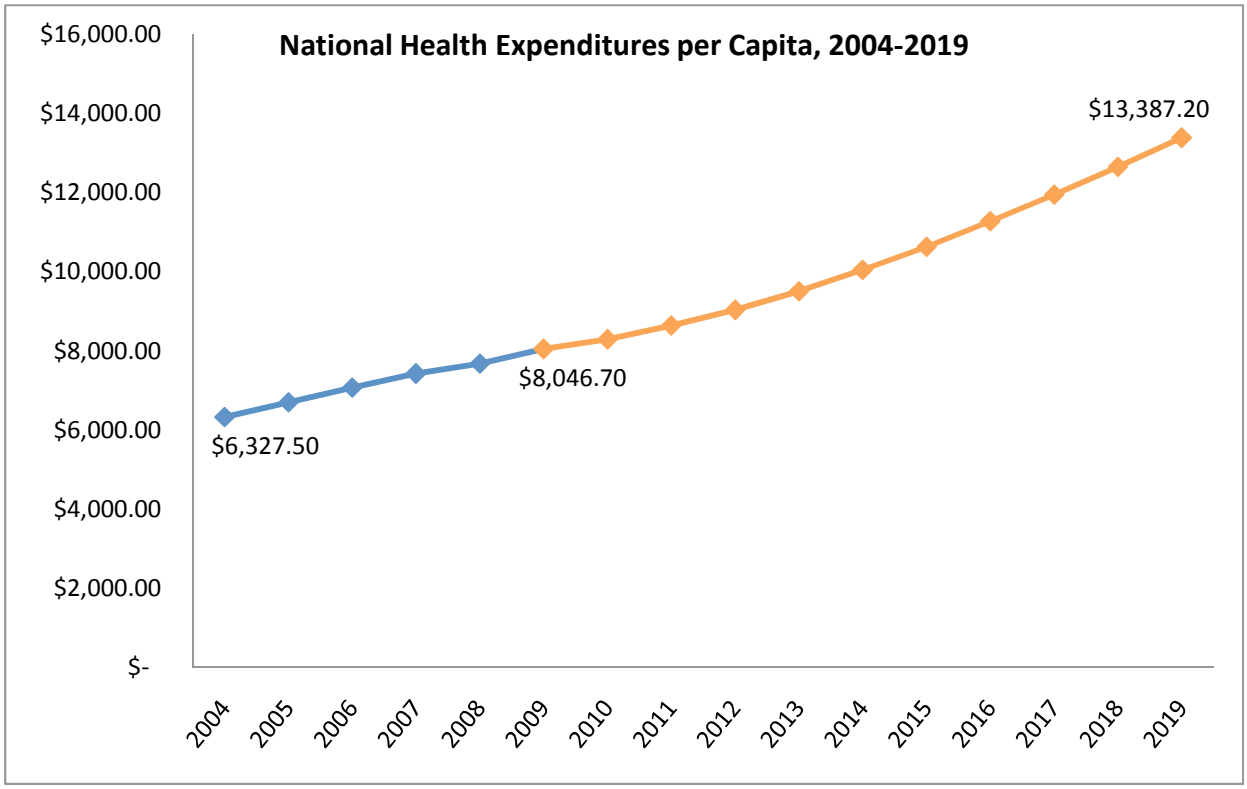
Second, is that many of the baby boomers are going to retire at the same time. Usually, one would want the best for our baby boomer friends and why shouldn't we? Boomers may have experimented with LSD while listening to the Beatles together, burned their bras in concert, made it through the Vietnam and been blessed enough to walk away from that tragic war but now boomers will be encountering another obstacle mutually.

Most baby boomers have their retirement money invested in institutional ETFs and mutual funds such as Fidelity, Vanguard, Merrill Lynch and other big banking names in the same fixed income funds or large blue chip companies. The financial advice baby boomers received most likely told them to 'diversify' and buy these quality names. What financial advisors to the baby boomers probably failed to realize is that when the other approximately 77.999 million baby boomers decide to retire they will be selling their securities to get cash, and in the process driving down the value of everyone's holdings in this large liquidation. This scenario, combined with the dismal performance that most likely resulted from the Great Recession of 2007 to 2009, is likely to place more baby boomers in the untenable situation of not being able to achieve their financial independence during their golden years.[8] Although every individual's situation is different, Hoe Brothers Investment Management believes that unfortunate baby boomers may have to face a later retirement to make up for the lost returns resulting from the possible inflationary period approaching or depressed returns from the market. Non-baby boomers may be affected in their stock portfolios by the mass liquidation that is approaching. Is there a silver lining for this situation? There's always hope that with the right planning and guidance a shaky foundation can be turned into one that is sustainable.

Medicare is another social program with good intentions that is unsustainable in its current form because of possible austerity that may be imposed upon the US government during a sovereign debt crisis. The fiscal year 2011 budget request for the Centers of Medicare and Medicaid services is $784.3 billion in

[8] http://www.metrowestdailynews.com/business/x427979693/Baby-boomer-retirement-may-be-a-bust

mandatory and discretionary outlays, a net increase of $48.3 billion over the fiscal year 2010 mark.[9] This amounts to approximately 5.3% of GDP. With Medicare, Medicaid and overall healthcare costs growing at a rapid clip, there is little doubt in our minds that the US government will make more attempts to constrain and reduce costs. President Obama's most recent attempt at this was his healthcare reform that provided great headlines but actually resulted in many unintended consequences that will negatively affect baby boomers. The recent Healthcare reform bill does many things; chief amongst them is to reduce the Medicare reimbursement rate by 21% (recently the U.S. House of Representatives approved a six-month stay on the Medicare cuts)[10] that doctors receive for each patient they examine. While the reimbursement rate may decline in the future, there is no present incentive on the demand side for patients to reduce their consumption of services. There's no doubt that anyone who is being examined by a medical professional would want the best treatment available, which includes numerous tests, but as a more than necessary amount of medical services is consumed, price of care increases. Additionally, the cost of healthcare increases further, resulting from doctors that are willing to dispense additional tests in a bid to prevent the risk of malpractice suits. This results in costs climbing faster than a monkey going up a tree after a banana,



Note: Figures from 2004 – 2008 represent historical data; data from 2009 – 2019 represent projected data.
Source: Centers for Medicare and Medicaid Services; http://www.cms.gov/NationalHealthExpendData/downloads/proj2009.pdf

while reimbursement rates are set to decline. This is not sustainable and will not be sustained. We are already beginning to see the effects of the new legislation. Doctors are no longer accepting new patients. "Last October, the Mayo clinic decided that it could no longer accept Medicare patients at its two primary-care clinics in Phoenix. And the media increasingly report other cases. For example, an elderly woman in Virginia Beach, VA, recently called 40 primary-care doctors, none of whom would accept Medicare

[9] http://dhhs.gov/asfr/ob/docbudget/2011budgetinbrief.pdf
[10] http://www.massdevice.com/print/news/house-issues-six-month-reprieve-medicare-cuts

patients anymore. One can reasonably presume that many patients have had similar experiences without reporting them to the media."[11]

The concerns that we want our investors to contemplate will depend on what stage in life you are at. If you are a golden baby boomer, then making sure that your retirement plans include a contingency plan for higher medical costs that Medicare and Medicaid will be unlikely to cover is a must. The US government will most likely continue to reduce their reimbursement rates and the burden will shift onto the individual. We believe the cost of living expenses will also rise as a consequence of government monetization of debt, and seniors should anticipate this and protect themselves by ensuring that their income streams are inflation protected. For the post baby boomer generations, we anticipate that Social Security in its effective capacity will be bankrupt for lack of a better word by the time a large number of individuals reach retirement age. There may still be payments made by the government, but the real purchasing power afforded by these payments will most likely be de minimis. Medicare and Medicaid coverage will also be drastically reduced for the post baby boomer generation, and if it is not then the quality of coverage will not be sufficient. We only point these realities out so that preparations can be made to ensure that these pitfalls don't affect you.

> *"There is no medicine like hope, no incentive so great, and no tonic so powerful as expectation of something better tomorrow." – Orison Swett Marden*

5. Elephant in the Room: The Commercial Real Estate Debt Bubble

"I'm right there in the room, and no one even acknowledges me."

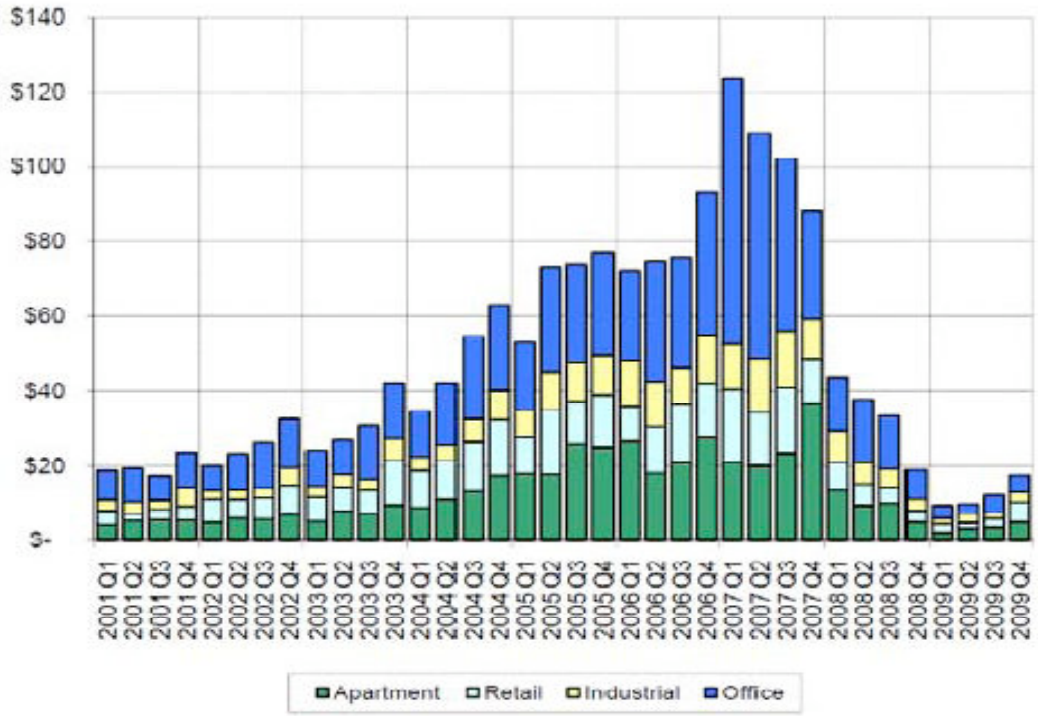
Source: The New Yorker

The Congressional Oversight Panel released a report[12] in February 2010 highlighting the risks that commercial real estate losses posed to the stability of the financial system. There's a pretty good chance that you haven't heard about this elephant in the room. When I was scouring the news sites as I usually do I saw a few headlines that briefly mentioned the report, but after the 24 hour news cycle passed, the report was swept into obscurity. Well, now the elephant has swept obscurity under the rug and will soon be vying for your attention. The panel concluded that between 2010 and 2014, roughly $1.4 trillion in commercial real estate loans will reach the end of their terms. Of this $1.4 trillion in commercial real estate loans, approximately half were "underwater" in February 2010 and the most significant commercial real estate loan losses are projected for 2011 and beyond (losses at banks are estimated to be as high as $200-$300 billion and we are already seeing the effects of this on the FDIC—refer to charts below). The

[11] http://www.pacificresearch.org/docLib/20100608_HPP62010_F.pdf
[12] http://cop.senate.gov/documents/cop-021110-report.pdf

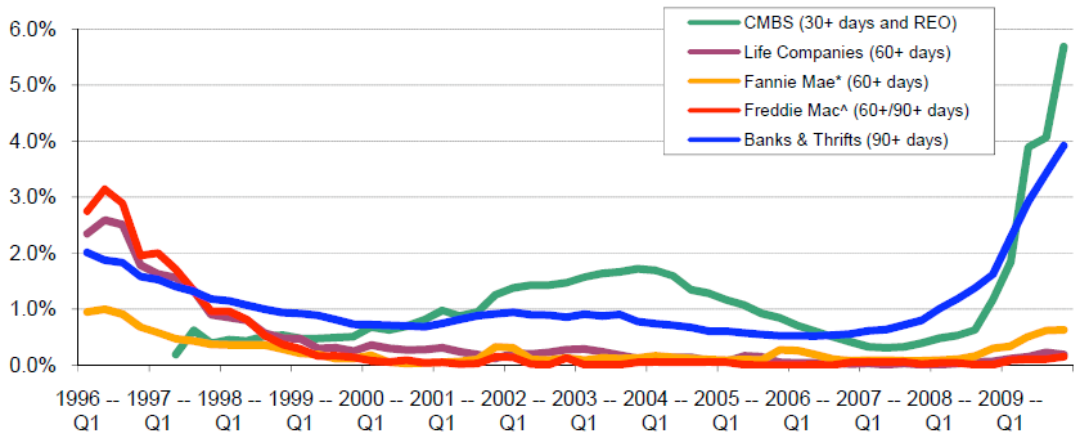
commercial real estate debt bubble should be important to you because it will have a direct impact on your lifestyle. Vacant office complexes, hotels and retail stores could lead directly to lost jobs. Foreclosures on apartment complexes could push families out of their residences, even if they had never missed a rent payment. Banks that experience commercial mortgage losses, or are reticent to lend in an increasingly risky environment, could in turn further reduce access to credit to more businesses and families thus accelerating a negative feedback loop. There are already anecdotal reports of empty office complexes, hotels and retail stores closing down and as you travel around town, if you pay attention, you may observe numerous "For Lease" signs.

Commercial/Multifamily Property Sales
in billions



Source: MBA Quarterly Data Book; Real Capital Analytics

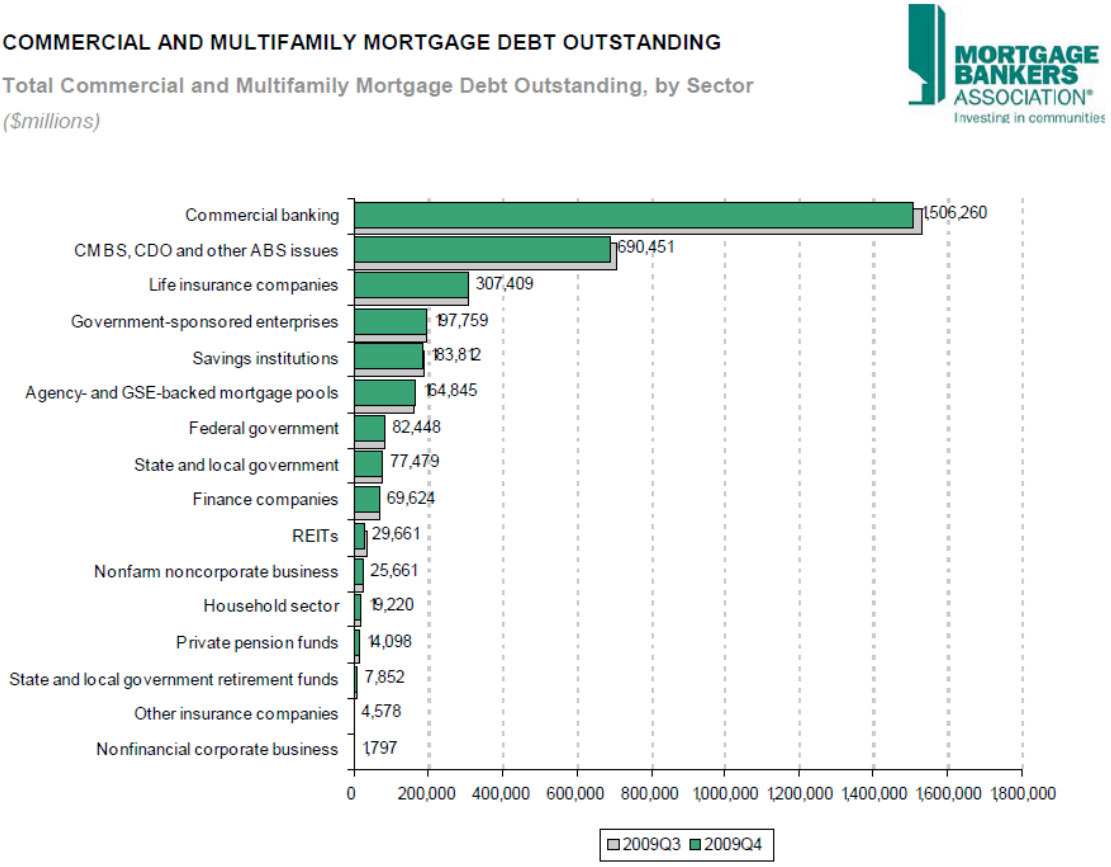
Commercial/Multifamily Delinquency Rates



Source: MBA Quarterly Data Book; Wachovia Capital Markets; LLC and Intex Solutions, Inc.; American Council of Life Insurers; Fannie Mae; Freddie Mac; OFHEO; and Federal Deposit Insurance Corporation

Average Vacancy Rates

Source: MBA Quarterly Data Book, Property and Portfolio Research



Source: Flow of Funds Accounts, Federal Reserve Board of Governors

Source: MBA Quarterly Data Book

"Problem List" Continues to Grow

The number of institutions reporting quarterly financial results declined by 80 in the first quarter, from 8,012 to 7,932. Forty-one FDIC-insured institutions failed during the quarter, while 37 institutions were merged into other charters. Only three new charters were added during the quarter, and all three were charters formed to acquire failed banks. The number of insured commercial banks and savings institutions on the FDIC's "Problem List" increased from 702 to 775 during the quarter, and total assets of "problem" institutions increased from $403 billion to $431 billion.

Source: FDIC Quarterly Banking Profile – First Quarter 2010

Statistics At A Glance

Historical Trends

As of March 31, 2010

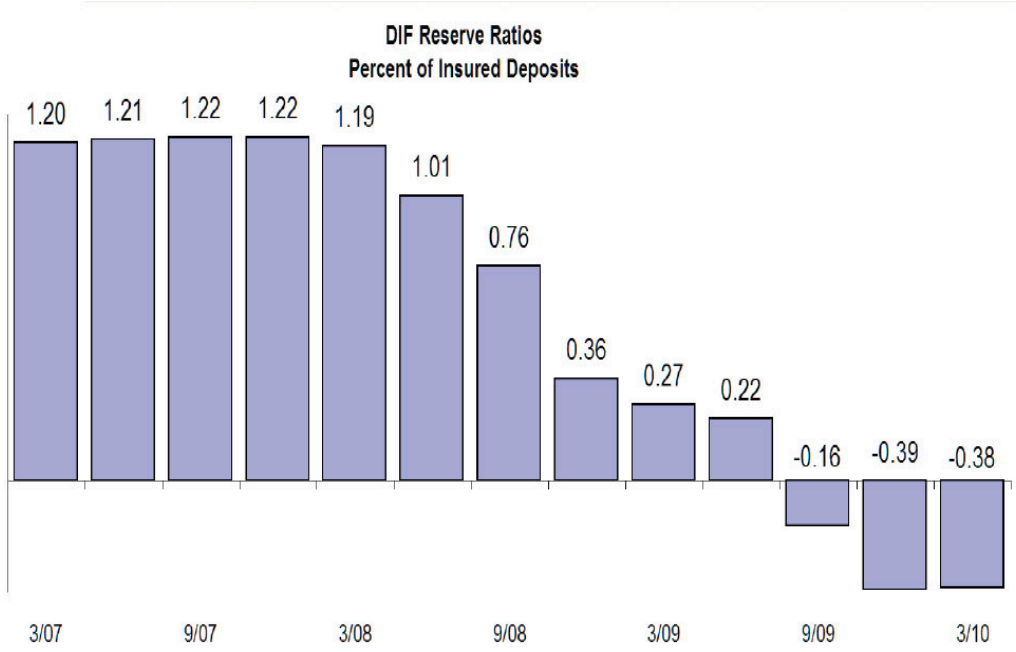
Dollar Amounts in Billions		2010 YTD	2009	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992	1991	1990
Commercial Banks		6,772	6,839	7,086	7,283	7,401	7,526	7,631	7770	7,888	8,080	8,315	8,580	8,774	9,143	9,528	9,941	10,452	10,959	11,463	11,921	12,343
New Charters		2	25	89	164	178	166	122	110	91	126	190	230	188	187	145	102	50	58	72	105	163
Mergers		33	152	261	282	305	269	261	224	276	354	452	416	557	598	552	606	548	501	425	443	389
Savings Institutions		1,160	1,173	1,219	1,251	1,279	1,307	1,345	1,411	1,466	1,534	1,589	1,642	1,690	1,780	1,926	2,030	2,152	2,262	2,390	2,561	2,815
New Charters		1	6	9	17	16	13	6	8	4	20	33	40	33	12	12	9	18	9	8	9	28
Mergers		4	27	32	39	37	41	58	49	56	63	81	80	114	127	108	116	109	111	84	72	64
Problem Institutions																						
Number		775	702	252	76	50	52	80	116	136	114	94	79	84	92	117	193	318	575	1,066	1,430	1,496
Assets	$	431	403	159	22	8	7	28	30	39	40	24	10	11	6	12	31	73	348	601	837	647
Combined Dep. Ins. Fund																						
Fund Balance	$	-20.7	-20.9	17.3	52.4	50.2	48.6	47.5	46.0	43.8	41.4	41.7	39.7	39.4	37.7	35.7	28.8	23.8	14.3	0.2	-6.9	4.1
Insured Deposits	$	5,463	5,392	4,749	4,292	4,154	3,891	3,622	3,452	3,384	3,211	3,055	2,869	2,850	2,746	2,691	2,664	2,589	2,602	2,675	2,734	2,760
Reserve Ratio	%	-0.38	-0.39	0.36	1.22	1.21	1.25	1.31	1.33	1.29	1.29	1.36	1.38	1.38	1.37	1.33	1.08	0.92	0.55	0.01	-0.25	0.15
Number Failed Institutions		41	140	25	3	0	0	4	3	11	4	7	8	3	1	6	8	15	50	179	268	381
Failed Assets*	$	22.140	169.709	371.945	2.615	0.000	0.000	0.170	0.947	3.383	1.821	0.414	1.592	0.290	0.028	0.233	1.226	1.601	9.977	89.554	143.455	146.586
Number Assisted Institutions		0	8	5	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	2	3	1
Assisted Assets*	$	0.000	1,917.482	1,306.042	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.034	0.079	0.014
Estimated Losses(DIF)	$	6.305	35.615	17.982	0.120	0.000	0.000	0.004	0.066	0.376	0.271	0.032	0.616	0.226	0.005	0.061	0.113	0.194	0.698	7.447	15.120	22.030
Resolution Receivables**	$	39.091	37.288	15.766	0.808	0.482	0.533	0.722	0.784	0.793	1.429	0.354	0.805	0.757	1.114	4.45	4.143	8.197	13.396	27.824	18.675	12.935
Number of FDIC Employees* (Includes RTC before 1996)		6,822	6,558	4,988	4,532	4,476	4,514	5,078	5,311	5,430	6,167	6,452	7,266	7,359	7,793	9,151	11,856	17,526	20,994	22,459	22,586	19,247

* Prior years have been revised to reflect failed/assisted assets as reported on the Call Report for the quarter prior to failure/assistance.

** Includes remaining receivership assets from prior years

*** Beginning in 2008, FDIC began reporting the number of FDIC employees based on a new, full-time eqivalent methodology.
Prior years have been revised to reflect the number of employees as reported in the FDIC Annual Report.

Source: FDIC



Source: FDIC Quarterly Banking Profile – First Quarter 2010

Source: Bureau of Labor Statistics

Deposit Insurance Fund Balance and Insured Deposits ($ Millions)

	DIF Balance	DIF-Insured Deposits
3/07	50,745	4,245,447
6/07	51,227	4,235,314
9/07	51,754	4,243,129
12/07	52,413	4,292,940
3/08	52,843	4,439,491
6/08	45,217	4,468,240
9/08	34,588	4,558,937
12/08	17,276	4,775,133
3/09	13,007	4,831,129
6/09	10,368	4,817,614
9/09	-8,243	5,304,695
12/09	-20,862	5,392,677
3/10	-20,717	5,462,644

Do you have a FDIC Insured Bank Account? THE FDIC HAS NO MONEY LEFT! They are $20.7 billion in the hole.

Hoe Brothers Investment Management expects the commercial real estate debt bubble to negatively affect the economy over the next three to five years. Access to less credit, higher interest rates, a sustained level of high unemployment and a risk to stock market returns are factors that must be planned for. We recommend that our investors minimize their personal and/or business debt and be prepared for several years of depressed growth in the economy. On the contrary, if you are an individual that finds themself with a strong financial position the next several years will give you the opportunity to invest in businesses, office complexes and retail operations that may be "diamonds in the rough" that are selling for an attractive price relative to their value. In other words, if this commercial real estate debt bubble causes further distress when it "pops," this may provide for an attractive opportunity to obtain prime investments. We liken it to buying the kitchen sink and getting the house thrown in for free!

6. Peak Oil: Even the Rappers Get It

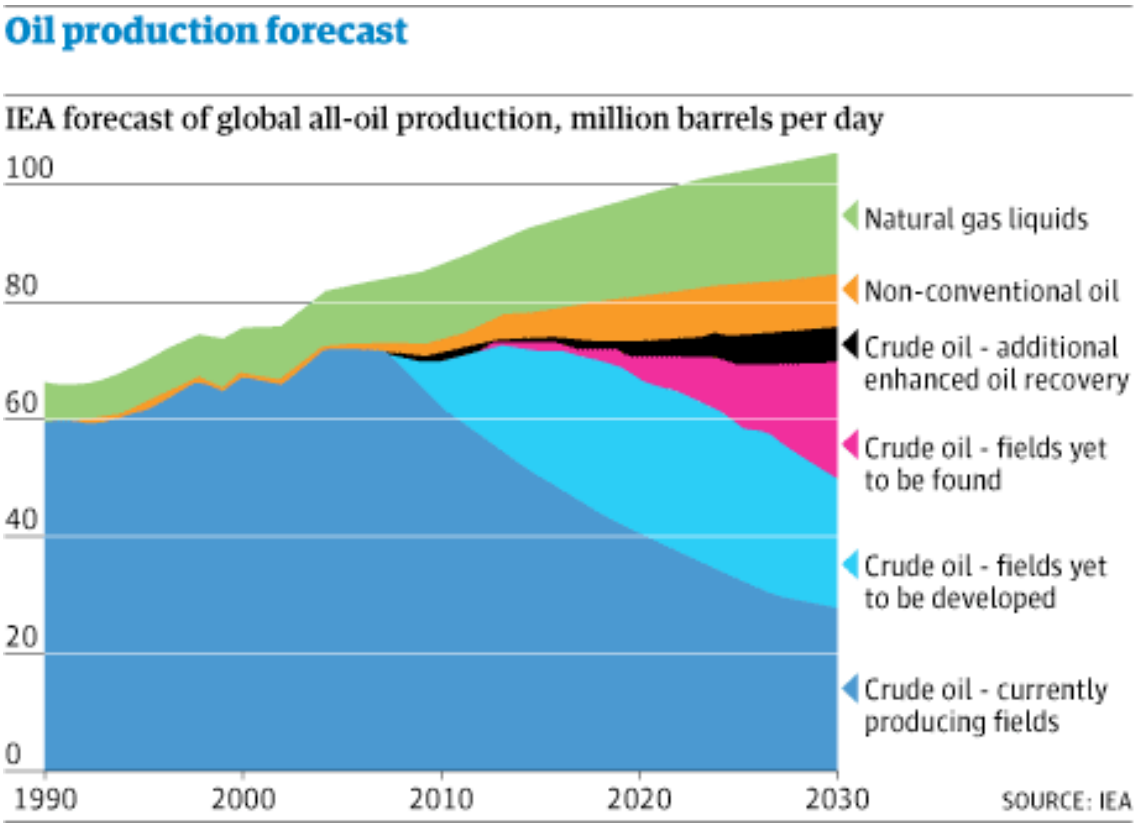
Williams and his brother Ronald "Slim" Williams founded Cash Money Records, the music label behind such artists as Lil' Wayne. Their foray into energy with Bronald, a name that blends Bryan and Ronald, prompted Houston investment bank Tudor Pickering Holt & Co. to quip that this may be a sign of the end of an oil-market rally. (Hoe Brothers Investment Management doubts the end of cheap oil.)

Source: Photo and Excerpt Bloomberg News

Many figures throughout history have had to deal with skepticism when they have proposed theories that ran contrary to common belief. We have many nicknames for these types of people: "Crazy. Lunatic. Conspiracy Theorist. Genius." Christopher Columbus dealt with a majority of the world believing that the world was flat instead of round. Copernicus faced the risk of oppression for his heliocentric belief that the sun was at the center of the universe instead of the earth. We've had to persuade others that viruses and germs were the source of illness versus an imbalance of the humors (earth, wind, fire, water elements) and now we can chalk another person up to the list who was initially ridiculed then proved correct by the facts. Marion King Hubbert predicted in 1956 that US oil production would peak in roughly 1970 and continue to decline. Hubbert was initially scoffed at by his peers, but his prediction has proved remarkably prescient. Today, with a global population of roughly 6.8 billion people,[13] of which approximately 2.0 billion is now shifting into middle class status, the demand for energy will continue to climb at a higher rate as these consumers purchase automobiles, utilize higher amounts of electricity for modern day appliances and luxuries and everyday living. There is no articulate way to put the situation into words. Eight US presidents have gone on TV to talk about energy policy but have not succeeded in presenting a viable plan. Bluntly put, there is not enough oil for the entire world. The world demand for

[13] http://www.census.gov/main/www/popclock.html

oil will be roughly 95 to 105 million barrels per day by approximately 2020.[14] According to a June 10, 2010 IEA Oil Market Report, the global oil supply in May was 86.3 million barrels per day.[15] Demand is outstripping supply and eventually this will lead to an energy crunch that will have severe ramifications across our economy and in our daily lives.



Alternative energies, while painted to be promising, cannot provide enough energy for the world to use. What is the solution for our energy problems then? In the short term, you will see more plays for continuously risky methods of oil extraction. The British Petroleum disaster in the Gulf Coast is a horrible disaster and the President has placed a moratorium on offshore drilling (which has been recently overruled), but in the long term we believe that it is unlikely that the ban will last. The US need for energy is too great. What is the option? Have less oil and risk a shutdown to some portions of the economy? Ration gasoline so that citizens do not drive? This is highly unlikely. We believe that deep-water drilling, shale gas plays and higher technologies will serve to aid in the short-term fix but there is no long-term solution to our oil thirst. In the intermediate term, as oil supplies dwindle we will most likely see an "arms race" to secure oil supplies. China, Russia, France, Germany and most of the rest of the world also feel entitled to oil and have made investments around the world and will defend them. A flashpoint where these conflicting interests are likely to erupt is in Iran. According to a NY Times interactive[16], there are currently 46 active companies profiting from investments in Iran. These companies are from France, Germany, Japan, South Korea, Brazil, Spain, Norway, Netherlands, India, Switzerland, Sweden, Luxembourg, Britain and even the United States. Taken from a list compiled by the UJA Federation of Northern New Jersey,[17] China, Russia and countries listed in the NY Times Interactive are also major

[14] http://www.reuters.com/article/idUSLDE61316Y20100204
[15] http://omrpublic.iea.org/currentissues/full.pdf
[16] http://www.nytimes.com/interactive/2010/03/06/world/iran-sanctions.html
[17] http://www.ujannj.org/local_includes/downloads/21816.pdf

investors in Iran's oil sector having invested billions of dollars. The US is not a major investor but this has not precluded our country from wanting their oil. Under the half-guise of wanting to stop the threat of Iran's Nuclear Program (which is a threat as well), the US is trying to plant a flag for a cause to invade Iran, along with the help of Israel, to appropriate Iran's oil by military force. This is not the US official party line and the main stream media will not dare to publish this fact in fear of retaliation by opposing interests, but the US Government's chase for oil is like a boy or girl's chase in the mating-dating game. Often times when dealing with the opposite sex in the mating ritual, "What they say and what they mean are two different things?" Some girls say they want the knight in shining armor but end up with the bad boys while guys say they want the wifely, sweet girl but date the rhymes-with-rich-but-starts-with-the-letter-B girls. Our government is no different. Uncle Sam says he wants to spread democracy and freedom, but in this case wants oil. When we attempt to invade Iran (we already have battleships, aircraft carriers and troops along the borders and the Israeli Air Force has been reported to be stationed in Saudi Arabia), we would not be surprised to see a coalition between Russia, China and the larger European countries effectively threaten to veto our actions by force. This could lead to a very dangerous situation involving an escalation of tensions that our world has not seen since World War 2. I hope it does not come to this.

Source: The Economist

Despite our wishes that the road finds an alternative energy path away from this possible outcome, we are realistic and expect continued higher oil prices, lower levels of production going forward and future instances of ecological disaster as the world scrounges for oil. This oil crisis will provide for many opportunities for investment. Smaller exploratory oil companies, oil equipment companies, coal miners, railroads (that transport the coal) and various alternative energies may offer chances to capitalize on this trend. We cannot predict which of the alternative energies will eventually be adopted in the future, but ironically the driver that leads us to the solution will be high oil prices that spur entrepreneurs to attempt to develop a solution for us all.

7. China: The Great Imbalance

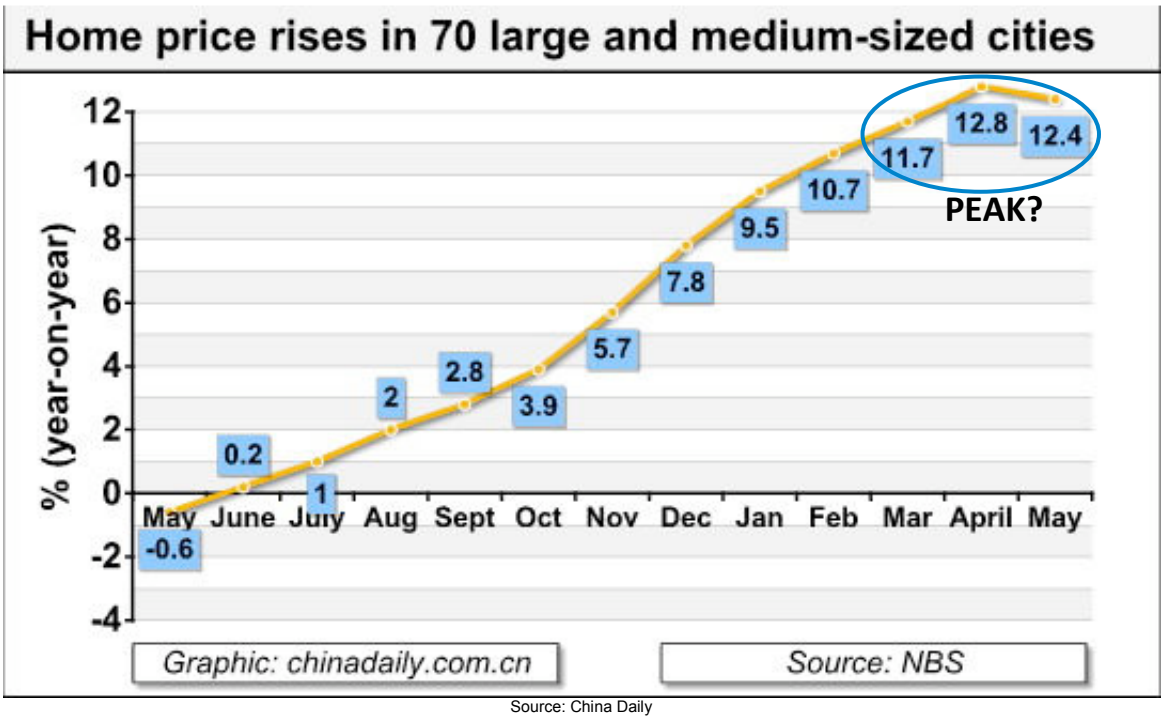
"Made in China." It's a familiar phrase to everyone globally. This manufacturing "mark of the beast" is found everywhere on clothing, electronics, toys, shoes and a whole plethora of other goods. Do you have an iPhone? Yes, it is made in China. Perhaps the recent media reported suicides that took place at

FoxConn, the Chinese company responsible for constructing your phone from its components, brought that to your attention. At last check, there have been approximately thirteen individuals at FoxConn that have attempted suicide (with ten being successful). Although there has been no official explanation, the most likely cause is due to poor working conditions. "Twenty-something" year old workers were required to work as much as a thirty-four hour shift,[18] with very few rest breaks allowed to toil away for a monthly wage of $132 [RMB 900].[19] This wage has been raised recently by up to 65%[20] as a result of the bad publicity arising from the rash of suicides, but to counter this salary increase a large portion of the manufacturing has been shifted to lower income outlying areas. After the FoxConn incident, the media published numerous reports of other factory workers striking in an attempt to gain higher wages. Honda, KFC and smaller electronics companies were all parties to higher wage negotiations and we expect to see this trend continue, especially in the face of the suspected higher than officially reported inflationary trends that are resulting from China's monetary, fiscal and currency policy.

After reading the last paragraph, you may be wondering why those tidbits should even be relevant to you? Well in this interconnected world many seemingly unimportant things do have tremendous effects. Remember the butterfly in the Chaos theory that could cause a typhoon halfway around the world? This is your butterfly and it's flapping its wings. The youth of China that have been working under sweat shop conditions to subsidize the American lifestyle of being able to purchase the new iPhone 4, HP Computers, toys, and clothing no longer want to subsidize you. The Chinese youth want higher wages and better working conditions and they will inevitably fight for and receive them in the next few years. The higher costs will be paid by the American consumer. At first, manufacturers will attempt to shift their production to lower cost countries like Vietnam and Bangladesh in response to this trend, but workers there will eventually end up in the same place as the Chinese workers: demanding better living conditions and wages. Workers in emerging markets (I personally dislike this term since many of the 'emerging markets' are actually more technologically and socially advanced than the US now) in their chase for a bigger piece of the pie will cause the American lifestyle which is full of leisure to become one that necessitates more work for a smaller wage. We are seeing and will continue to see this rebalancing over the next decade or two. Social unrest from groups (Unions in particular) that may not understand this dynamic will most likely arise and in response our politicians will impose various regulatory schemes in an attempt to curtail this structural change. Protectionism, which intends to protect certain special interests and sectors, likely will have the unintended opposite effects when countries retaliate against our industries by establishing their own protectionist policies of their own. We've seen this before with the Smoot-Hawley Tariff Act during the Great Depression and it may be repeated again.

A Consensus view that the global market, especially Wall Street and the global politicians hold, is that China is the metaphorical engine that will power us out of this current economic malaise. While we do subscribe to the belief that China's future (and Asia overall) in the long run is very bright, in the near term we do not have as strong a conviction that China may be able to be the world's savior. China's 2009 GDP, a measure of its economic output was roughly $4.9 trillion. The US and EU each had GDP of about $14.3 trillion and $12.5 trillion.[21] This means that China's GDP is only about 18.2% the size of the US and EU combined, and only 7.0% when taken as a percentage of total Global GDP of $70.2 trillion.[22] China does not yet have the muscle to turn the global economy on a dime. To add to this, China is in the midst of a world class commercial and residential real estate bubble that may have already peaked and there is a high probability of a hard landing.

[18] http://www.gizmodo.com.au/2010/06/another-foxconn-employee-dies-after-working-34-hours-straight/
[19] http://www.nytimes.com/2010/06/03/business/global/03foxconn.html
[20] http://www.boston.com/business/technology/articles/2010/06/10/foxconn_wage_hikes_will_be_passed_on/
[21] http://www.imf.org/external/data.htm#data
[22] https://www.cia.gov/library/publications/the-world-factbook/geos/xx.html



Source: China Daily

China has gone to great lengths in its bubble, building entire empty cities! The city of Ordos is the most popular one (there are plenty of videos on youtube) and while real estate officially makes up 10% of the Chinese economy, the unofficial figure stands closer to roughly 60% of the economy once all real estate related industries are included.

Ordos: These are all empty!
Source: New York Times

A property crash has the potential to drastically slow the Chinese economy down. While many market pundits exclaim that the Chinese government will never let the market crash, we are a bit more skeptical on this point. Hoe Brothers Investment Management believes that the Central Government of China will use every means to maintain social stability in their country. This has always been their main focus so

that the Communist Party can continue to remain in power. Doing everything to maintain social stability does not equate to preventing a property market slowdown.

8. Other Blips On Our Radar

The global stage is much too complex for a single investment note to capture all of the factors that turn the cogs in the machine of life, nonetheless we want to leave you with a list of other areas that we are keeping our eyes on. This is by no means an exhaustive list of every possible risk to a portfolio. We are prime believers in the KISS principle (Keep It Simple, Stupid) and when we're as brilliant as Stephen Hawking we'll let you know. Here's the list:

a) North and South Korea conflict – Sunken submarine, conflicting reports and joint US-South Korean military exercises taking place.
b) Afghanistan – A failing war, opium[23], rare earth minerals, did I mention opium and strategic access to Iran (Afghanistan and Iraq surround Iran – we control Afghanistan and Iraq).
c) Iran – Uncle Sam says, "No Nuclear for you. Your Oil for us." Warships are in the process of surrounding Iran with eleven warships just recently passed through the Suez Canal. Signs of an impending attack are building.
d) Global Food Shortages – Who is becoming a farmer these days? Nobody we know.
e) College Debt Bubble – Similar to sub-prime lending in for-profit schools
f) US Government Surreptitiously Eroding Civil Liberties - Free markets are products of free societies.
g) Continued High Employment May Lead to Unrest in the U.S. – The U6 unemployment rate is 16.6% as of May 2010. Seventeen percent (**17%)** of the total non-institutionalized population (persons not in jail) are on **food** stamps, also now known as the Supplemental Nutrition Assistance Program**.** [40,157,395 people on food stamps[24] ÷ 237,499,000 total non-institutionalized population[25]]
h) Australian & Canadian property bubbles.
i) High Frequency Trading: Front running your stock exchange orders legally but not ethically.
j) Katla Volcano – Icelandic volcano has the potential to shut down European skies again if it blows.

9. What We're About

The world is a very complex place. Chaos theory, the theory that says a butterfly flapping its wings has the potential to cause a typhoon halfway across the world, is a theory we subscribe to. There are far too many known risks to worry about, let alone those that we do not even realize exist. So how can we protect ourselves and our investments from being caught off guard? We subscribe to Benjamin Graham's (Warren Buffett's mentor) philosophy of purchasing investments that have a competitive advantage and large margin of safety at a discount to its intrinsic value. This is like paying $50,000 for a $250,000 Ferrari with a roll cage and a large car insurance policy. We have the advantage of great handling and a strong engine to give us an advantage in a race, but in the event that a tire blows out or there's an obstacle on the road which we do not anticipate the roll cage and car insurance assures us that we will not sustain catastrophic wounds. We treat our attitudes for your investments the same way. We have a capital preservation focus, with a contrarian, value investment approach. We do not know what will happen in the short term, but we feel that by recommending investments that we understand, have a

[23] Opium from Afghanistan is sold to Europe and Russia. http://afpak.foreignpolicy.com/posts/2010/06/21/russias_dangerous_fix
[24] http://www.fns.usda.gov/pd/snapmain.htm
[25] http://research.stlouisfed.org/fred2/series/CNP16OV

strong competitive advantage, with the right management (if it is an equity recommendation) for the right price, we can minimize the threat of substantial principal loss. If we do not see any opportunities in the market, then we will tell you so. We will not attempt to force you into a position for the sake of it.

We do not blindly believe in diversification for the sake of diversification. Hoe Brothers Investment Management believes in quality. We would rather have you own several high quality investments instead of one hundred mediocre ones. Besides who wouldn't want five Lebron James and Kobe Bryants instead of thirty bench players? The buy and hold for the long-term belief is one that we do not blindly subscribe to either (studies have shown that buying and holding for the long-term works well in undervalued and fairly valued markets, but greatly increases the probability of loss if done during an overvalued market).[26] One other thing that we would like you to consider. Hoe Brothers Investment Management is a Registered Investment Advisor and not a Financial Advisor. They sound similar (this is on purpose – you can thank the financial industry and their lobbyists), but the two have many differences. The largest difference is that as a Registered Investment Advisor, we have a **fiduciary duty** to you, much like a CPA or lawyer. The law requires us to place our client's interests ahead of our own. This doesn't bother us as our client's interests already supersede our own for we believe the fact that if we treat our clients well, protect their portfolios and ethically produce investment returns the rest will take care of itself. Many financial advisers also place their client's interests ahead of their own. We know many financial advisers that care for their clients, but they are not required to possess a fiduciary duty to their clients. This small difference can lead to drastic differences. We cannot recommend an investment to you without ensuring that it is suitable while a financial adviser may sell it to you as long as you express interest. While we do not believe that this is detrimental to all clients, many financial advisers are placed into the untenable situation of balancing the client's investment needs against their Company's push to maximize sales and profits. We are paid a percentage of the assets under our management. Other advisers receive commissions or bonuses based on sales. Be sure you understand how your adviser gets paid and what incentives his or her pay structure has on your portfolio.

We aim to be your counsel and your friend. You know what they say about friends. Friends are like bras: close to your heart and there for support.

[26] Michael A. Alexander, Stock Cycles: Why Stocks Won't Beat Money Markets Over the Next Twenty Years. Writers Club Press, New York, 2000.