THE RUDD COMMENTARY

{ JULY 2012 }

We are pleased to publish this edition of *The Rudd Commentary*, which is a periodic publication designed to bring you a professional opinion on the current investment environment and some developing trends. Please feel free to forward *The Rudd Commentary* to family, friends, and business associates who might find this information valuable.

THE CRITICAL ELEMENT

I recently decided to take my three oldest children on a field trip to the bank. Much like George Banks in Disney's *Mary Poppins*, my intent was to encourage my children to save by exposing them first hand to the greatest financial system in the world. As is common with most new experiences with children, "why?" clearly dominated our discussion. As we worked through our afternoon, our trip covered some interesting topics. My children didn't cause a run on the bank as happened to poor Mr. Banks, but there was a run on me with some very simple questions. I am proud to say that after having the courage to ask "why?", my children now understand the financial system better than many bank tellers.

In the recently ended quarter I received a similar "why" from many of our clients. Why should we invest amongst all this bad news? After all, the markets seemed impotent during the latest quarter and gave us little to be hopeful for the balance of the year. Most of the concerns are currently centered around the future cost of the recently upheld health care legislation, further slowing internationally, and the continued efforts of the Federal Reserve to stimulate the economy. In thanks for the simple wisdom of all children, I want to share a few of the "why's" from my recent trip to the bank and use these simple concepts to shed some light on what recently has been some very dim news.

Q: Why are we giving our money to the bank?

A: ***We have faith that it will be there when we need to spend it.***

Our ability to buy, sell and save (or invest) is based on our faith in the U.S. financial system. In the past, dollars could be converted into gold at a fixed or market price. As our economy has grown, total transactions for all the goods and services we consume take more dollars than can be exchanged for gold. Now these bills in our wallet represent a "share in America" similar to the stock of a company. More basic, they measure the American people's faith in our government and the Federal Reserve system.

It is this faith that directly answers this question. We have some choices on what to do with all the hard work we accomplish throughout our life. We can spend it as it comes in, keep it in dollars in our safe, loan it to someone like the bank (your checking account is a loan to the bank), or store it in an equity investment. If you are not going to spend your money in a reasonable amount of time you should consider investing it and try to achieve an acceptable rate of return higher than inflation.

Q: Why is that big vault door left open all the time?

A: ***Because there's no money in there.***

Before I began working with private clients, I was a securities trader for a large financial institution. Every day I traded hundreds of millions of dollars of a security known as "commercial paper" with well known banks, mutual funds, insurance companies and large corporations. In other words, I "borrowed" this money from these companies so that my employer could fund new business lending, finance special projects, and even meet its bi-weekly payroll obligations. Money Market funds typically made the largest trades (single trades in excess of $200 million were not uncommon) as they tried to earn interest on very large cash deposits. Who do you think this money actually belonged to?

Most individuals simply do not realize that the money that shows on their bank or money market statements is not physically located at their institution. For example, as of 12/29/2011, the current reserve requirement for U.S. banks was about 10%, and of that, only a portion is actually held at the bank in its vault.[1] Every time you make a $100 deposit at your bank, you cause more money to be created because the bank only has to keep about $10 and can loan out or invest the rest. Now both you and the guy who just took out a car loan from the

[1] Source: http://www.federalreserve.gov/monetarypolicy/reservereq.htm

same bank are using these same virtual dollars as their own. With each bank deposit, more money is created. It's that simple.

Q: Why would we want to invest our money?

A: ***It is the best choice available if we are not going to spend it soon.***

If we do not spend all of the money we earn, we are left with three choices: we can stuff our mattress, loan it to someone else and charge them interest, or we can own something such as real estate or equity ownership in a company (stock). Let's take a look at holding on to cash versus the two basic investment options.

HOLDING CASH: Since we are simply placing dollars in our safe or favorite mayonnaise jar, this option does not generate any return. As an added bonus, inflation will erode the value of this cash over time. This silent thief has averaged about 3% a year in the United States since 1926.[2] This depreciation would cause $5,000 to lose approximately $700 in purchasing power in 5 short years. Inflation is caused by several factors, but two are worth mentioning here. Since we cannot exchange dollars into gold any longer, the number of dollars printed and your faith that you can use them at a later time will determine their purchasing power over time. In this environment, how do you feel about holding more cash than you plan to spend over the next six months?

LOANING MONEY: Loans include everything from interest bearing bank accounts to a certificate of deposit (CD) to corporate and municipal bonds. If you ever wonder if you have a loan investment, excluding mutual funds, loans will have a "rate and a date" (example: 0.5% until Dec 21, 2012). These types of securities have been a very important part of investors portfolios for the last decade with treasury bonds returning 5.7% from 2002 - 2011 annually.[3] However, recent rates on high quality loan investments such as CDs are still very low as the Federal Reserve has held short-term interest rates near zero. In this environment, how would you feel about investing your money in a government bond for 10 years at 1.5%?

EQUITY OWNERSHIP: The other kind of investment option involves owning something rather than loaning to someone. Residential real estate, oil and gas royalties, common stock, stock mutual funds and fine art are all investments that are owned. The goal is to harvest profits from your investment and/or sell your ownership interest at a greater value than you paid for it. Ownership in most cases does not pay a stated return if held to maturity as many loan investments do, but owning equity has historically led to higher returns than owning debt due to an investor's willingness to take on more risk.[4] Ownership also offers a natural solution to the inflation problem of holding cash and loan investments. Companies that you own can raise the price of their goods and services if needed and return higher profits to owners (shareholders). Prices of assets such as real estate, precious metals, and fine art tend to increase over time due to inflation and demand on their relatively fixed quantities. In this environment, how would you feel owning equity in a daily living product manufacturer that pays a consistent dividend?

WINDS OF CHANGE »

Make no mistake, there is a lot going on right now that will affect how we chose to invest our hard earned wealth going forward. It is natural to look at some of the recent changes in our environment and want to bury our money in the back yard. As I hope I have explained very simply, choosing not to invest is choosing to hold cash in an environment with record low interest rates, a rapidly increasing money supply, and the prospect of higher taxes. Instead of asking "why should I invest?", the question should be "where should I invest?". Even the worst economic uncertainties and government legislation can create investment opportunities.

A SPOON FULL OF SUGAR »

Children are truly a blessing to their parents. Acting at their worst, children perfectly remind us of humanity's vices such as selfishness, impatience, stubbornness, and our lack of emotional control. Acting at their best, children force their parents to adopt courage, practice personal responsibility, search for simple explanations to life's problems and remember that our faith is the most critical element of a healthy society. Thank you to Katelyn, Madeline, William, Caroline, and our much anticipated "Baby Rudd" for helping me to proceed with courage amid challenges that are sometimes hard to swallow.

Invest Long and Prosper,

Josh Rudd

[2] Source: 2012 Ibbotson SBBI Classic Yearbook
[3] Source: Barclay's Capital U.S. Treasury Index
[4] Source: 2012 Ibbotson SBBI Classic Yearbook. Based on compound annual returns of 9.8% on the S&P 500 index versus 5.7% on Standard & Poor's long-term government bond total return index from 1925-2011.

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