

Inside Business

The Hampton Roads Business Journal

Insidebiz.com

July 15, 2011

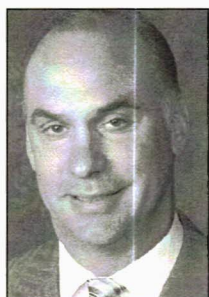
\$1.00

THE EXPERTS:

INVESTING

Q2 highlights the need for cap spending

With Q2 now history, I believe we have no choice but to cap our spending. I would suggest to you that the IMF would take exception to any other



MICHAEL SEARS

action on our behalf. Let us consider for a moment what the specifics of our debt are according to a Reuters' article on May 19:

- President Ronald Reagan once famously said that a stack of

\$1,000 bills equivalent to the U.S. government's debt would be 67 miles high. That was in 1981. Since then, the national debt has climbed to \$14.3 trillion. In \$1,000 bills, it would now be more than 900 miles high. In \$1 bills, the pile would reach the moon and back twice.

- U.S. Treasury Secretary Timothy Geithner has said that the United States borrows about \$125 billion per month.

- Stan Collender, a budget expert at Qorvis Communications, said the biggest sum most Americans have ever handled - in real or play money - is the \$15,140 in the original, standard Monopoly board game. The U.S. borrows about 185 times that amount each minute.

- In a 31-day month, that means the United States borrows about \$4 billion per day.

- The U.S. borrows more than \$40,000 per second. That's more than the cost of a year's tuition, room and board at many universities.

- The net worth of Bill Gates,

roughly around \$56 billion, could only cover the deficit for 15 days.

Let us also consider some other recent issues that we have experienced. There has been a sharp sell-off in the area of commodities with the precious metals and energy going appreciably lower. As countries such as Greece suggested that it may be prudent to leave the euro zone, there was a move afoot to get to safer ground. This flight to quality has traditionally meant buying from yours truly, the U.S. Treasury.

I will suggest that this is perhaps the very reason that our dollar has not significantly devalued and/or been replaced as the world's reserve currency, the latter not being beyond comprehension given our lack of fiscal responsibility.

At the end of the day, what does this really mean? Ultimately, it means a loss of confidence and direction, which traditionally does not bode well for the market. So, the real question is how do we protect ourselves against another Black Swan event - something not expected and hard to predict?

MANAGING IN THIS MARKET

In this type of market environment, you may want to consider some form of equity hedge. For many years we have seen this done by large institutions and more specifically by insurance companies. They traditionally have a very defined discipline as it relates to risk management and I am of the opinion if it is prudent for them, why is it not for you? After all, they are in the risk management business and without

proper and prudent risk management tools in place, your retirement income may very well be at risk.

In today's world you can add some form of equity hedge into your portfolio as part of a blended approach from various money managers or mutual funds, or directly through a wealth manager who specializes in this area.

These hedges should not be confused with hedge funds. Equity hedges are simply designed to stabilize a portfolio that ultimately may prove to lengthen the life on an income stream in retirement.

BEWARE THE INVISIBLE

As you navigate the markets, you need to be aware of invisible circumstances that can be dangerous. To illustrate this point, consider a trip to the beach. Upon arrival, to your dismay, there are signs saying that the beach is closed due to rip tides. While unfortunate, you at least were afforded a warning.

Consider for a moment that you went to a beach that was unattended by any lifeguards and had no warning signs posted. While the water may appear to be a little rougher than usual, it does not appear to be life-threatening, so you dive in only to find out that there is a very significant rip tide below a seemingly calm surface. Before you know it, the danger is upon you and you have little to no recourse. This is how even the most seasoned of swimmers have perished. How does this relate to the current-day marketplace?

The extensive use of derivatives in

continued overleaf...

...continued

our global marketplace has led to the creation of an undertow, or rip tide, that may not be seen until it is upon us. This is evidenced by the vanishing of a prominent Wall Street firm, Lehman Brothers, with an exceptionally storied 150-plus-year-old history, or a \$1 trillion insurance company, AIG, which virtually collapsed overnight.

Let us examine in a little closer detail the evolution of the derivative as it relates to the destabilization of our global markets. In general, derivatives were used as currency hedges or to stabilize even more volatile energy prices. As the degree of sophistication, or creativity as many would argue, advanced, so did the use of the derivative as a tool of speculation. When you apply leverage tools to a market that is already unstable by its very nature, you have a powerful compounding effect that for many years went unregulated for all intents and purposes.

Coincidentally, last month it was reported that JPMorgan had agreed to settle fraud charges. According to the Securities and Exchange Commission, "J.P. Morgan Securities, a division of the bank, failed to tell investors a hedge fund helped select the investment portfolio and then bet that

the portfolio would fail." This is a classic example of what can go on behind the Wall Street curtain, especially if no one is watching.

The end effect is that on a world level it has been suggested that there exists some \$600 trillion in derivatives, a figure that represents roughly 10 times the world's total GDP, according to the Bank on International Settlement.

This is where the visibility issue is important. As a general statement, a money manager has to fully disclose his or her use of leverage and derivatives. This is traditionally seen in the investment discipline description and traditionally further seen in the transaction updates that the managers email to their clients.

Depending on the asset level of the client, it is my opinion that it is prudent to have a separate derivative manager, versus a blended style. That way you can more efficiently manage the allocations. It would also be prudent to have an active or proactive wealth management process that is defined prior to going this direction. It may be worth your investigation. In the end, the opportunities are there, as well as the "rip tides."

Be safe out there, and happy investing!

Michael Sears is a 1985 West Point graduate and owner of the Sears Group Inc., a wealth management firm based in Virginia Beach. He can be reached at 456-9124 or www.searsgroupinc.com.

Securities offered through Questar Capital Corporation (QCC), Member FINRA/SIPC. Advisory Services offered through Questar Asset Management (QAM), A Registered Investment Advisor. Sears Group Inc. is independent of QCC and QAM.