

Maybe Smokey the Bear Has a Point? Gregory A. Naylor 6/15/2010

Great news! We put out a catastrophic forest fire...

In our last newsletter we discussed the positive effects of the bailout, which may have prevented a breakdown in society itself. However, to continue the forest fire analogy, the bailout did not actually fix any underlying problems. So, bad news! We did not allow the forest fire to clear away the deadwood and create new growth.

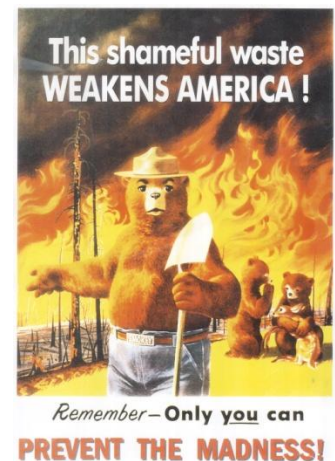
As economic 'firefighters,' there are now three possible courses of action. First, we can continue to fight the fire with all available resources. We can pour money and resources into firefighting, sending planes and helicopters to dump water, along with men and trucks to fight on the ground. Second, we could realize the error of our ways and allow a huge forest fire to work unhindered. When the next crisis occurs, we could walk away and let the fire burn out of control, waiting until everything has been destroyed before we start to rebuild. Third, we could start a series of controlled burns. As an optimist, I believe that our political and economic leaders are trying to pursue the 'controlled burn' strategy, but of course there are no guarantees in life. Let's look more closely at each of the three options.

1. Continuing to fight the forest fire with all available resources is not an attractive scenario. In economic terms, this means continuing to bailout a host of failed institutions. We would continue to give money to foolish or greedy bankers who made bad loans. We would extend credit unceasingly to automotive industries that are uncompetitive. We would continue to subsidize the housing market at the expense of other industries.

The deadwood would pile up, and new growth would be further stunted. Our industries would become less competitive in the global economy. Money for education would continue to be constricted, and new jobs and technologies would move overseas. The modern-day Thomas Edison would not be able to start a business, because the government would be spending its money on bailing out the unprofitable candle makers. Let me emphasize that I do not believe this is what our current leaders are trying to do, but of course it is a risk.

2. We may have only postponed an even bigger fire. As lightning continues to strike we may not be able to control or extinguish every fire. Economic fires around the world could get out of hand. So far, when Dubai and Greece effectively defaulted, the world was able to contain the damage. However, lightning could strike in the form of another stock market crash, a currency crisis, or an even larger country default. There remains a risk of economic conflagration, despite coordinated efforts to prevent this.

For Americans who have seen their standard of living decline, their debts increase, and their jobs go away, this can seem a perversely attractive option. Wiping the slate clean in a sudden and drastic monetary dissolution, many indebted people might experience newfound freedom. However, with the world's central banks and governments working together, it does not appear likely that our economic system will collapse anytime soon.



Smokey's words lend credence to our analogy.

For better or worse, it appears much more likely that those who have borrowed money, wisely or not, will simply have to pay it back over a long period of time.

3. The third scenario, which I believe our economic and political leaders are trying to accomplish, is a controlled burn. They are trying to allow bad businesses to fail, without inadvertently punishing good businesses. For example, the government bailed out many financial institutions, but not all of them. Hundreds of banks have been allowed to fail, with their healthy loans being sold to healthy banks and their unhealthy loans being taken over by the FDIC. Larger banks that could have failed but did not, are forced to pay back their loans to the government. This is actually happening, and in some cases the government is recouping its investments with a small profit. The government is also trying to make sure that credit is available for new growth; the small businesses of America. However, this is proving to be problematic as many banks are not able or willing to start lending again. The controlled burn is proceeding imperfectly, and its success or failure is relative day to day.

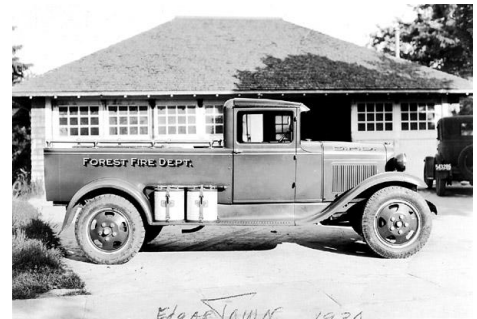
Firefighting in the 1930's versus Today

These three options did not fully exist in the days and months leading to the Great Depression. Technology has changed, along with the field of economics. The tools and institutions of the global economy have changed as well.

Today, information flows around the world almost instantaneously. As soon as a problem exists in a small bank in Germany or a factory in China, the world knows about it. Fires that are started by lightning do not have a chance to burn unseen for an extended period of time. In the 1920s and 1930s, information moved much more slowly, usually via steamships rather than email. By the



time a fire's location and extent were widely known, it was sometimes too late for an effective response.



Pictures are worth a thousand words...

Also, today's firefighting tools are much different. The crisis in Greece could not have been solved without the IMF, which did not exist in the 1930s. Back then, if a nation's crisis became bigger than its central bank could control, there was no other defense.

Firefighters in one town did not help those in another, even if technically they could.

Today we understand that letting a fire burn in one part of a forest does not mean that our part of the forest is protected. So the IMF works to prevent a coordinated response. But it is designed to be a controlled burn. Before receiving assistance, Greece had to make changes to get rid of some of its deadwood: unrealistic retirement ages, unsustainable government borrowing, etc.

Finally, our understanding of economics has changed. We do not believe that we can live permanently in boom times, but nor do we believe that painful depressions are necessary. The goal of economists today is to mix the good with the bad in a blend that produces relative stability. Unemployment is high, but some people will still find a way to go back to school to get different jobs. Banks are failing, but healthy banks are still able to extend credit to business.

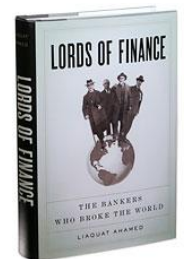
An economist's controlled burn is no different in its final outcome than a forest fire, it is only different in its pacing. A forest fire moves much faster and more drastically. It is likely that we will continue to have recession and unemployment for many years in some sectors of the economy, while growth recovers in others.

Investing Conclusions

What can we do as investors? First, stop lending money to the deadwood. If you are over the age of 50, it is probable that you are continuing to invest in the struggling housing sector. Your 'retirement age' mutual funds are making loans to the U.S. government, Fannie Mae, Freddie Mac, and other institutions with broken balance sheets. It feels better than 'the stock market,' but it will not likely produce the desired results. Diversification does not have to mean buying a bunch of bad investments along with a few good ones. Please talk with your broker or advisor about diversifying away from these loans.

We can take lessons here from an odd place: post-World War I Germany, where inflation was rampant and change was everywhere. Here is a description of this era, taken from Liaquat Ahamed's 'Lords of Finance.'

Inflation transformed the class structure of Germany far more than any revolution might have done. The rich industrialist did well. Their large holdings of real assets - factories, land, stocks of goods - soared in value while inflation wiped away their debts. Those who made up the backbone of Germany - the civil servants, doctors, teachers, and professors - were hit the worst. Their investments in government bonds and bank deposits, carefully accumulated after a lifetime of prudence and discipline, were suddenly worthless. [They were] Forced to scrape by on meager pensions and salaries, which were decimated by inflation.



There is an easy way for an individual investor to align themselves with the rich industrialists described by Mr. Ahamed: buy stock in the healthy industries of the real world. We do not know whether tomorrow holds deflation or inflation, and we cannot predict fire or rain. But we do not believe that paper money and government subsidy offer better answers than human industry and ingenuity. We study history, and we diversify, and we plan. And we choose to support good business and a better future through our investing decisions.

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