



Quarterly Commentary 2nd Quarter 2004

As we put the finishing touches on our recent article “It’s Time to Bust Up Fannie and Freddie” (a copy of which is included with this correspondence and the edited version of which appeared in the July 5th edition of **Arkansas Business**), it struck us that there are many areas of our society where the laws of economics are being circumvented. Examples usually exist where politics has intruded on economics to erect a force or counter force to alter the outcome where free, market-based economics would take us. We are not here to argue against these policies, because they are usually undertaken to benefit the common good. We raise the issue to point out that when the laws of economics are subverted, many times unintended consequences follow and produce “side effects” that may be equally as bad as or worse than the original problem. These can be viewed as costs to society and the economy, the bearing of which may be recognized as necessary to benefit the greater good. Some of these efforts have been with us for so long that we accept them as a fact of life, especially since many of our citizens have never known otherwise. We wish to discuss a few examples of what we are talking about because it is important to recognize that when the laws of economics are violated, clear economic signals to society may be one of the first casualties, causing society’s participants to adopt behavior that is counter to their long-term prosperity.

Social Security

We do not pretend to be experts on this topic, but there are a few basic concepts that we believe to be true about this program. Social Security is no longer (if it ever was) an actuarially sound program. It is a “pay as you go” program that is dependant on the current workforce at any one point in time to provide or supplement the retirement income of those no longer working, either due to having attained “retirement age” or disability. Back in the ‘70s, the cash flows from this monster, which had been segregated and off-limits, were commingled with the general budget of the federal government, producing a very muddy picture of the financial soundness of this program **and** the federal government. Most demographic experts believe that the

future costs of this program will become even more onerous on the working class as our society ages relative to the number currently employed. There is no doubt that the program has assisted millions in their elderly years and helped the overall economy by providing them a safety net. However, in some instances it may have reduced the incentive to work and save by those members of society willing to accept the government as the source of their standard of living.

Employer Provided Health Insurance/Medicare and Medicaid

Private health insurance provided as an employee benefit came into the mainstream in the years following World War II. The private health plans caused a modest increase in total health care spending through the mid 1960's. With the enactment of Medicare and Medicaid in 1965, a huge change in the economics of medical care took place in our country. Government spending as a portion of total spending on medical care immediately went from 15% to 25%, advancing rapidly to today where government spending makes up more than 50% of total medical expenditures in our economy. These health insurance programs have had both good and bad side effects. Our elderly population and most, but not near all of our working population is protected from financial ruin due to health problems. Also, the advances in medical technology that we have enjoyed like no other country in the world would probably not have been possible without the large increase in resources flowing to this sector of the economy. The downside has been that most people today consume health care using someone else's money for the most part, which generally does not result in economically sound decision making. Also, the system tends to treat illness with much less emphasis on wellness, which seems to have resulted in a trend toward behavior that is not healthy (e.g. smoking, obesity, alcohol and drug abuse).

Deposit Insurance/Too Big To Fail Concept

Deposit insurance and government bailouts of large industrial corporations or financial institutions protect investors from their bad decisions. The lesson here, particularly for those managing some of our largest organizations, is that there will always be a government backstop to protect anyone from a loss resulting from bad management. Thus, there is no downside to adding more risk in hopes of attaining a higher return. We can think of no better examples than the Savings and Loan Industry of the 1970's and 1980's, or Fannie Mae and Freddie Mac as they exist today (see

attached article). Other examples have been the Penn Central Railroad, the domestic airline industry (ongoing), Chrysler and the hedge fund Long-Term Capital Management. Extending this line of thought would lead you to government subsidy programs for industry and agriculture, which are prevalent throughout the world and create such problems for clear pricing and production signals that room does not allow for us to elaborate here.

Compensation of Corporate Management/Incentive Stock Options

We maintain that through various methods used to entrench corporate management, the law of supply and demand is not at work when it comes to the compensation of large public corporation executives. While there has been a move toward stricter corporate governance, management compensation (not just salaries) continues to be priced at levels that seem ridiculous to us. Incentive stock options granted to managements tend to be structured as upside rewards with no downside penalties. These plans then carry a perverse incentive for managements to take more risk than they might otherwise.

Government Welfare Assistance

A well intentioned effort by our federal government to wipe out poverty in our country had ruinous effects on work ethic and family moral values in our society. However, all is not lost, as a bipartisan effort resulted in the reforming of this program that most observers agree is now much improved.

Conclusion

There are definitely other examples that we could mention, but the message that we are trying to convey is that we must always be aware that there are economic forces at work, not all of which are fundamental, that might be moving us toward behavior with unintended consequences.

It is obvious from this discussion that our system is not always one of free markets and high efficiency. We live in a country so wealthy and so highly productive that free markets can sometimes be encumbered in an attempt to solve a problem while still maintaining a high standard of living. Lest you come away from this reading with a negative conclusion, let us share a recent observation. One of us was fortunate (if that is the right word) to spend some time in Europe traveling (as opposed to vacationing) recently. We knew before we embarked on our journey that we live in the greatest

country with the highest standard of living on earth. As novice travelers, we just did not realize to what degree this was true. In spite of all of our country's problems and all of our disagreements on how to solve our problems, we are very fortunate by our place of birth to reside in this great land.

2nd Quarter Market Summary

The stock market as represented by the S&P 500 Index performed very similarly to the first quarter. Total return for second quarter was 1.72%, bringing the market to a year-to-date return of 3.44%. Oil and gas as well as automotive related stocks were good performers for our portfolios during the period. Gold stocks, which had traded ahead of their fundamentals to some degree, made a correction.

It was a disastrous quarter for bonds, one of the worst if not **the** worst on record. The total return for the ten year U.S. Treasury note was -5.05%. Since that return included a little more than +1% of current income, it means that the price declined over 6% during the quarter. As we mentioned on one or two occasions in the past, when you start from such a low rate, a small increase in yields has a really large negative impact on bond prices. This is what happened during the second quarter.

Yuan Zhang

We are pleased to have Yuan Zhang on our staff this summer as an intern. Yuan is currently an MBA candidate at Wake Forest University. She is from Shen Zhen, Guang Dong Province in the People's Republic of China. Her undergraduate training is in environmental engineering, and she has commercial banking experience in the PRC. Yuan is picking up finance a lot quicker than we are learning Cantonese!