

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

June 15, 2008

Investing with Care in a Turbulent World

Oil prices have risen six-fold since 2002, causing serious inflation pressures here and around the world.

Energy-related stocks have been a superb investment for Core.

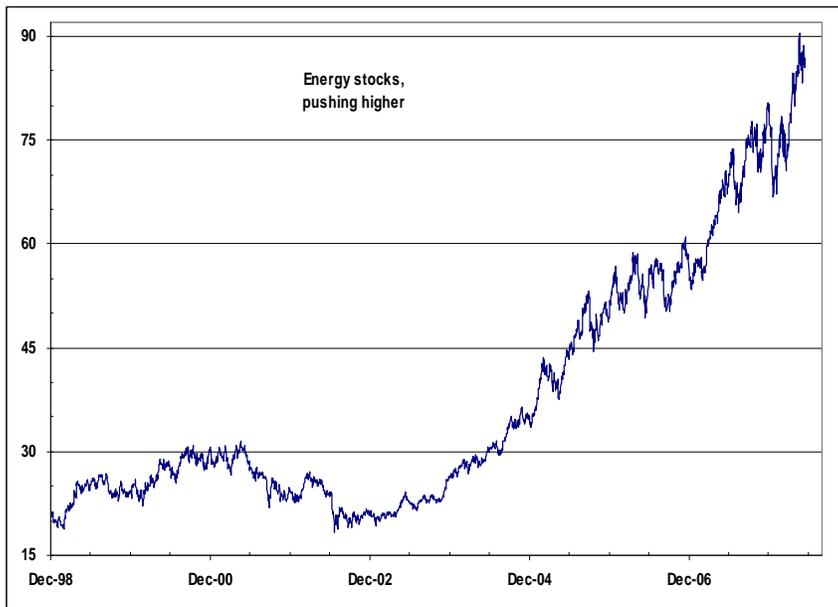
Oil prices have reached \$138 per barrel, on their way to higher levels still. Prices of food have risen very sharply around the world, causing riots in some countries. Inflation rises everywhere. Housing prices in the United States continue to fall, the availability of credit has shrunk dramatically. When Bear Stearns went under in March, the international financial system tottered perilously; the creative rescue by the Federal Reserve preserved order. Despite aggressive moves by the Fed, financial markets are still weak and volatile; losses in the sector continue to mount. For several years, beginning in 2003, markets rallied during a benign period of easy money, placid globalization and dynamic growth in emerging economies. Is this present period a less benign one? Yes. But, just as we have preserved your investment capital

during the year-long turmoil, we have investments--and we will add more--that will thrive when conditions improve. In this letter, I will look at various pieces of the new configuration, consider what has changed and what has not, and put forward some ideas about investing now. First, oil.

Oil prices began to rise from \$20 per barrel in 2002, as the US recession ended. (Core began investing in this oil-related securities in the second half of 2003. We have been adding to these investments since.) Prices did not rise in a straight line: Hurricanes Katrina and Rita caused a spike to \$70 in 2005; a pullback in the beginning of 2007 brought crude down to \$50 per barrel. But for several years, higher oil prices did not seem to put a damper on economic activity, nor did high prices appear

to lead to wider inflation. No longer. In 2007 and 2008, prices rose at an ever more rapid rate, crossing \$100 without stopping. The high prices are certainly feeding into general inflation and the prices are taking a terrible toll on many individuals and many industries around the world.

In geopolitical terms, there are winners and losers. The winners are the oil exporters into whose coffers ever more dollars flow. The biggest beneficiaries appear to be the Saudis and the Russians, who have built enormous reserves of foreign currencies from the ever-growing oil-export income. (The Saudis are accumulating \$1 billion per day in revenues from their oil sales.) At the beginning of this decade, Russia was nearly overwhelmed by indebted-

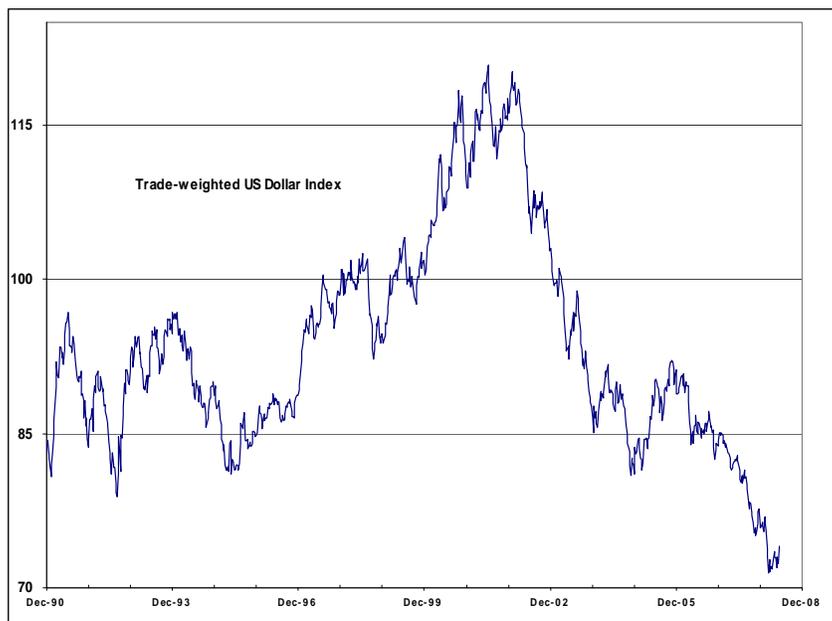


By

Jack Mayberry

Crude oil prices now exceed \$125 per barrel; we face the prospect of higher prices still. We have large investments in energy-related stocks and our portfolios continue to benefit from these investments.

Past performance is not a guarantee of future returns.



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ness, but now has paid down all its debt and accumulated significant reserves. As a major supplier of natural gas to Europe, its political power has increased significantly. The Saudis appear to be using their oil wealth to strengthen their political position, to stabilize the Middle East and to limit the growth of Iranian power. China may be a significant loser in high oil prices: its economic growth depends importantly on oil-burning industries. As oil prices increase, its poor population is hard pressed by higher prices. Hence, China--and other East Asian countries--subsidize low fuel prices, a growing burden for them. The United States has been hurt less by rising oil prices in this decade than in the '70s, because of our de-industrialization in recent decades and the increasing importance here of the service sector. That the United States still produces oil domestically helps.

Food is similar to oil; its prices soar, causing widespread social problems and threatening worse. Poor people and poor countries, because they spend a large portion of income on food, suffer most. Poor countries find that food subsidies for their citizens become ever more expensive, precisely when the apparent need is greatest. The recent Cyclone Nargis in Burma offers a chilling glimpse into the way that global climate change will worsen the food crisis: The Irrawaddy Delta has been a major rice producing and exporting region. The storm has damaged production, at least for this year, if not for longer.

Changing patterns of growth. For many years, the American consumer has been the driving force in the world's economy. Dynamic growth in the developing world changed the distribution of economic activity. Just as economic growth in India, China and other Asian countries spurred the demand for oil, food and other commodities, so this growth in developing countries offsets the present weakness of the American economy. In recent months, we have seen benign

effects from this: although the collapse of the housing market has pulled incomes down and slowed consumer spending, these losses have been significantly offset by booming US exports, in part to newly-strong developing countries.

Changes in Dollar Policy. For several years the implicit--and utterly uncealed--US policy favored the decline in the dollar's value in relation to foreign currencies. The weak dollar policy helped the competitiveness of US exporters; it was a way to ameliorate America's large trade and current account deficits. Concurrent increases in dollar-denominated commodity prices have been seen as a tolerable by-product of our weak dollar policy. In recent months, however, as oil prices have soared, their damage to the American economy and to the world's has become unavoidably obvious. The risk that inflation could become, once again, an ingrained feature of life seems to have changed policy makers.

The 'rule' in the United States has long been that it is only the Treasury Secretary who speaks about currency matters. The chairman of the Federal Reserve (always) and the President (usually) defer explicitly to Treasury in this. In the last two weeks, Fed Chairman Bernanke has made two speeches referring to the *problems* associated with a weak dollar-- in the last several years, Mr. Bernanke has given many speeches referring to the *benefits* we derive from a weak dollar. President Bush said "[w]e

want the dollar to strengthen”; and Secretary Paulson said he “would never take intervention ... or any policy tool off the table”. On evidence like this, we have cut our investments in foreign currency money funds sharply in the last seven weeks, from 23% of the assets we manage to 8%. The chart on the previous page shows the tiny recent upturn in the dollar. It does not look like much yet; indeed, when we look again two years hence, we will see whether this period was the turning point. My view is that the one-way trade on dollar depreciation has become much riskier. To keep risk of portfolio losses low, we have been selling your euros and yens.

Sums flowing to oil-producing countries are staggeringly huge. That shift in wealth from Western oil consuming countries to OPEC brings with it a similar shift in power from Europe and America to the Gulf countries and others.

Contraction of credit. Unrestrained and largely unregulated expansion of credit brought upon us the housing price bubble, sub-prime mortgages, very high levels of borrowing by individuals and institutions, enormous losses to people and institutions, and the near collapse of the financial system. Unsurprising, then, that in the aftermath borrowing has become somewhat rare and more expensive. Years of expansion of credit and balance sheets are giving way to shrinking balance sheets and contracting credit. There are investment implications: As balance sheets shrink, we can expect to make money by holding the debt of institutions whose credit-worthiness will improve. We will avoid investments whose success depends upon the expansion of credit.

Transfers of wealth. As oil prices increase, ever more money flows into the coffers of the oil exporters, as discussed above. Some oil exporters, like Nigeria and Indonesia, still need more money than they receive from their oil exports. Others, like Saudi Arabia and other Gulf states, Norway and Russia, accumulate reserves at an enormous pace. The Asian exporting countries--China, Taiwan, Korea, Japan and others--are doing somewhat less well now than in the last few years, because they are paying more for their own imports of oil and other commodities. But these countries have already accumulated huge reserves.

Much of the wealth flowing to OPEC countries comes back to US bond, stock and real estate markets. We can expect these ‘petrodollars’ to provide real support for the investments we make.

Current account surpluses for the OPEC countries now run at the rate of about \$500 billion per year. Unless oil falls very dramatically in price, these countries will continue to build enormous reserves, far in excess of what they can use internally in their own countries. Morgan Stanley estimates that OPEC countries hold \$2.3 trillion in reserves now, heading to \$3.3 trillion in two years.

In short, our portfolios benefit from the money flowing to OPEC and Asian exporting countries.

Although we may decry the increasing indebtedness of the United States and rue the transfer of wealth and power to the oil exporters, the investment aspects of this are not inherently bad for us. Much of the surplus is transferred into the so-called Sovereign Wealth Funds (SWFs) and then invested in the developed economies in the Europe and America. As we know, in recent years, a large portion of these funds has made its way into government bond markets of the United States, keeping long-term government bond yields at historically low levels. Last week came the announcement that Abu Dubai is purchasing a majority interest in the Chrysler Building, a beautiful monument on New York’s skyline. It is quite likely that SWFs will be significant buyers of equities and real estate in coming years. Much of this money will probably make its way into American and European markets. The portion of US markets that will be owned by Americans will probably fall in coming years, but we can expect plenty of foreign capital, including from the OPEC countries, to find a home in US markets. Because such enormous investments from

US markets are likely to attract a disproportionate amount of capital that will flow into investment markets from Sovereign Wealth Funds in coming years.

The flow of investment from SWFs can only be bullish for equities and real estate.

SWFs and others are on their way here in coming years, we can invest our capital alongside them and watch the value of our investments rise. In short, the flow of capital to OPEC and Asian exporters is probably bullish for our investments.

And, despite higher rates of economic growth in the developing economies than in Europe and America, it may well be that our equity and property markets will attract more foreign capital than will the developing markets. The greater maturity and transparency of our markets is a help. Moreover, if we are entering a new cycle of inflation--and it certainly seems that we are--inflation is likely to be lower (and less harmful to investors) in Europe and American than in developing countries. Our central banks are more sophisticated and have successful institutional experience in inflationary environments. And, as mentioned, the rich Western countries have a smaller portion of their economies adversely affected by rising oil, food and commodities prices than do the developing economies. This argues for keeping larger investments in America and Europe than we might if we simply considered differing growth rates and the accumulation of surpluses.

The Investment Environment is Difficult... ...The Results are Satisfactory.

This has been a very tough investment environment for a year. Adverse conditions--collapsing home prices, credit contraction, and rising oil prices--may continue. In this last year, when it has been so easy to lose money, we have been very careful and we have earned money for Core's clients. In the last twelve months, the US stock market, as measured by the S&P 500, is *down* by 12 percent. Core's portfolios in the aggregate have appreciated by a modest amounts: We are up by 2 percent. In absolute terms, of course, earning 2 percent is hardly worth shouting about. Remember, however, that Core's portfolios earned a lot of money in the four years up to last summer, in the aggregate more than 50 percent. During this present treacherous period, we are preserving those investment gains you earned in previous years. When this period ends, there will be, almost certainly, another extended period during which our portfolios can grow strongly. If we investors keep our capital intact while the markets are so negative, we can expect to earn fine returns again when more favorable conditions return. (The performance information here summarizes the returns across all the accounts we manage. There are variations among individual accounts, which arise from a range of factors: Some accounts have earned more; some less. Risk and return objectives vary among Core's clients.)

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a guarantee
of future returns.*

Favorable market conditions will return, of that we may be sure. The investment world is a large one and its dynamics change. Our job is to identify these changes as they develop, to invest carefully when conditions are dangerous, as they have been in the last year, and to invest opportunistically in the assets with low prices and good prospects. Please email me (JNMayberry@coreasset.com) or call (800 451 2240), if you wish to discuss any of this further.

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