

**July 4, 2010**

Dear Family and Friends,

As I spent the 4<sup>th</sup> of July 2006, I am spending this day . . . thinking.<sup>i</sup> As I shared my thoughts then, I share them now.

It has been a turbulent four years to say the least. The initial reception to the 2006 letter was disinterest. This was followed by commentary from some of you wondering if I had lost my mind (that by the way is a quote). As I continued to write about what I was seeing, several of you complained that I was “scaring” you. My response generally was to the effect that people should be scared. As it turns out many of you took heed and avoided some of the catastrophic losses when things turned out in many instances to be scarier than even I thought.

There is a disadvantage to having been so spot on in many instances. It has created with many a view that I actually know what will happen next or that I know what others should do. I will make it clear once again that I do not have the sure answer to either question. No person knows with certitude what will happen in the future or the optimal way to handle events unknown. The best anyone can do is to consider multiple scenarios and prepare as best to respond to them. I am my thoughts to assist you in making those determinations.

I will also note that the July 4, 2006 letter came with 3 binders and a couple hundred pages of support.<sup>ii</sup> Instead of duplicating such an effort, I am simply sending a letter this time. In this letter I recommend all of you invest in your network. I am part of that network and will always be as long as it suits you. You can self-select the degree to which you want to keep that line open (coming soon will be information on how I will be thought sharing through the internet for those interested).

I can be linked in – I am under Mike Keliher

I can be reached by email – [mkeliher@keliherconsulting.com](mailto:mkeliher@keliherconsulting.com)

And we are about to debut a revised website (check it mid-July or later) - <http://www.keliherconsulting.com/>

As I was writing this I lunched and found a book *Everyone Communicates Few Connect* – looks promising and I will be sharing better networking ideas therein

With that said, this is my “summary” of things on this 4<sup>th</sup> day of July 2010 . . .

## I. The Past

**July 4, 2006**

### **The letter**

The first 4<sup>th</sup> of July letter was composed four years ago. In it I shared my concerns that the massive real estate bubble was bursting, that the stock market was grossly overvalued and that there existed a ticking time bomb in the credit markets of hyper-leveraged derivative structures known as structured finance. I noted that a multi-year recession was imminent and that a traditional “diversified portfolio” of stocks would not prove to be diversified at all in the upcoming meltdown

### **The lessons**

#### **I learned**

All forecasts are dynamic and must be altered as events dictate. I was correct that the market would collapse. However in July 2006, the Dow was at about 11,000. In the next fifteen months the Dow moved higher as the news got worse. The Dow in fact topped not at 11,000 but instead at 14,300 in October 2007. It was not until October 2008 that the floor really dropped.

Being right does not ensure being profitable. I was short Fannie Mae for years. I knew it was insolvent yet trading in the 70s. I watched it drop to the teens. I saw Bear Stearns fail. I then saw Fannie Mae double in value in 3 days (from 17 to 35) in March 2008. It hit 35 on its way below a dollar in three months.

It is better to do nothing in most instances. Wait until the odds are really in your favor. Then wait some more. Then when you move, make it a smaller investment than you think.

The market is always open the next day (this is a variation of the prior) in essence, there will always be another great opportunity, so don't lament the ones you miss.

#### **Other lessons**

Daily, weekly, monthly and yearly balances are inconsequential. The only time that matters in investing is the time when you are converting a higher risk asset into cash.

It is imperative to understand the bias underlying any summary information. In particular, one must focus on the incentives of those providing information. Some examples:

- The investment bankers saying there were no problems just days before their companies disappeared (*Devil's Casino* is a good book about Lehman's implosion)
- Anything coming from government officials stating that things are improving, that problems are contained, etc. The goal of any and all such announcements is not to inform, it is instead to influence. In a macro sense, it is absolutely

appropriate for government officials to mislead the public. If the government at any point had said the financial system is failing, it would have had the same consequences as yelling fire in a crowded theater. Thus, the government is lying for the collective good. As individuals we must not be deceived.

There is little statistical significance to things touted as “never happening”. For instance, recall the statistics showing “real estate never goes down on a national basis.”

Keep your mind open to different ideas, in particular those that are significantly different than those shared by the crowd. Read *The Big Short* and *Crisis Economics* to see how wide spread the warnings were about structured finance problems

## **II. The Present**

**July 4, 2010**

### **The markets**

A second top was put in the last few months just over 11,000.

It is more likely than not that the March 2009 low of 6,500 will be broken in the next couple of years (keep in mind I said 60-90 days in 2006 and it did not happen for 2 years).

### **The economy**

The credit markets are not working.

The only reason any of the major banks are considered solvent is because they are no longer required to account for the losses on the book value of assets.

There will be massive bank failures in the next twelve months.

The gimmicks that have supported both residential and commercial real estate have about run their course and another significant leg down is underway.

Deflation will be taking hold as time wipes out the last resources of the unemployed (this figure is closer to 20% than it is to under 10%)

There is no aggregate backlog of demand for goods or services. The demand backlog is largely from those who are incapable of buying and without prospects of being able to buy in the future.

Government spending and job creation will keep the economy alive just as it did in the 1930s. There is way too much damage in the private sector in particular servicing current debt for private spending to increase in the short run.

## **Macro thoughts**

There will be a backlash in the 2010 election with Republicans gaining seats. The Republicans will win the 2012 Presidential election. Why? Because it is impossible for there to be a quick fix to any of the economic problems facing the world. Thus opposition parties will be able to claim that the party in power's policies have failed. I think this “blame the other guy” politics will continue through the next decade’s elections with each party in power being unable to “fix” things.

The problems in Greece are systemic in the EU. The bailouts have just begun and the size of the bailouts are as underestimated as where the problems attributed to subprime in 2007.

## **III. The Future**

The only thing I am certain about the future is that it will turn out markedly different than anyone can predict. If I knew what would happen, it would be easy to figure out how to act. Because no one knows what will happen, the best that can be done is to guess the probability of different scenarios occurring. More importantly, this process requires adjustments as events unfold. While I can’t tell anyone what they should do, I can share what I am doing and ideas that others might implement

### **What I am doing**

I no longer actively trade secondary markets. Instead I largely have been watching them run up the past year plus with the knowledge that markets can behave irrationally a very long while. When I do return to active trading it will be with defined risk strategies and with a thorough understanding that being “right” in the long run doesn’t matter if you go broke in the short run.

I am invested in:

Myself.

- I continue to learn (I got an MBA from U of M) and read several books a month.
- I have my own business
- I spend significant time networking

Private Enterprise

- Along with others I am creating what in essence will be private equity investment. I believe that direct investment in companies is preferable to gambling against the house on Wall Street.

Escaping the shackles of credit

- I like most took on way to much credit. I spent much of my future in doing so. I am in the process of paying off all my credit obligations and when complete will not be leveraging my future again.

### **What I think others should consider:**

You can “get rich quick”. Statistically there will be those lucky enough to win the lotto, get in early on Google, hit the jackpot in Vegas, etc. The probability that you will be such a person is extraordinarily low. The probability that pursuing such strategies will allow you to “get poor quick” is extraordinarily high.

Passive investing is unlikely to work– in particular utilizing any computer generated “average return” that predicts where you will be in ten, twenty or thirty years.

If you wish to invest passively - focus on risk more than reward – it is much more likely that you will be late to any trend in a secondary market than early. Chances are by the time you find the “next best thing” the smart money is leaving not coming in. The most important thing for you to do is not lose what you have rather than try to catch a shooting star.

Find someone you trust who manages money and see if they protected their clients from the huge risks in the last years. To the extent any money manager advises you to simply “stay in it for the long haul” I would keep looking. Once you have a good money manager, trust them. Stop looking at monthly, yearly, etc. statements. Stop chasing the latest hot thing. In particular for those who were fortunate enough to have an advisor that kept them out of the 2008 carnage don’t wonder why that manager did not participate in the rally of last year. The reason the money manager was not involved in the latest run up is the person understands that market gyrations in secular bear markets are the norm.

Invest in things you understand or can control. If you have a chance to buy a business, consider that before passively sitting in markets.

Look for investments that throw off cash examples being rental properties.

Actively prepare for a range of financial scenarios. Most importantly keep at least a two year cash reserve (this means government back securities and insured deposits) before thinking at all about more active investment.

Invest in yourself. This is your best investment. Be ready for scenarios where you lose your job. If you think it not possible, think about whether the people at General Motors ever thought they would be laid off. Invest in yourself by:

- Networking. It is in fact your most important job no matter who your current employer is. Also remember networking is a two way street. Watch out for others. Help those who need help.
- Keep current. It is a fast changing world. Keep learning be it through formal programs (example MBA), continuing education in your profession,

- Follow innovation. Learn how to network socially. Learn how to use your GPS (this is actually an inside joke about me).
- Read. If you wish to invest, do not read books about day trading, investing like Warren Buffet, etc. Instead read books about the history of markets (*Every Man a Speculator, The Panic of 1907, Panic*), the way Wall Street really works (*Wall Street versus America, When Genius Failed, Den of Thieves, Confessions of a Wall Street Analyst, Liars Poker*), major frauds (*Conspiracy of Fools, Smartest Guys in the Room, No One Would Listen, Extraordinary Circumstances, Predators Ball, The Battle for Wall Street*), psychology (*Predictably Irrational, The Upside of Irrationality, The Logic of Life, The Irresistible Pull of Irrational Behavior*), economics (*Crisis Economics, False Economy, The Holy Grail of Macroeconomics*), randomness (*Black Swan, Fooled by Randomness*), etc.

Prepare a worst case scenario for yourself and your family. If you don't upsize on credit you won't have to downsize. Most importantly understand that credit of any kind is a tax on your future income. In times when the stability of future income is in such question, credit must be used sparingly if at all.

#### IV. In Closing

**Do I think the world will end?**

No

**Do I think that the US is destined to be a third world country?**

No.

**Then what do I think?**

What I think is that the economic hard times will have to be commensurate with the good times. That means many lean years ahead.

It also means that there will be winners and losers as there are in any particular time period. The Great Depression is known for the substantial losses suffered by the multitudes. What is less known, is that great fortunes were made by the few.

I believe that the US recovery will take place as it always has because private capital is placed with private innovation. Growth will be real, not financial engineering. The winners will be those who participate actively at either end. Those who passively expect others to watch out for them will get back what they put in. Not much.

Happy 4<sup>th</sup> of July,

Mike K.

---

<sup>i</sup> [http://www.kelihercapitalmanagement.com/pdf\\_archive/july406letter.pdf](http://www.kelihercapitalmanagement.com/pdf_archive/july406letter.pdf)

---

<sup>ii</sup> <http://www.kelihercapitalmanagement.com/background.html>