# *The Derailleur*

***an environmentally and socially responsible investment newsletter***

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*"The world is wide, and I will not waste my life in friction when it could be turned into momentum."*

-- Frances Willard, activist, educator, writer and avid bicyclist (1839-1898)

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## Farewell Status Quo

For an idea of where the market is, it is important to see where it has come from over the past two years. The Federal Reserve has raised short-term interest rates one quarter-point at a time, 17 times over, from 1% to 5.25%. Back in 2004, 5-year Treasury bonds were earning 3%; today, their yields are around 5%. Each and every asset class – from stocks and bonds, to real estate and gold – went up, with money pouring into assets with higher expected returns. Over this period, the markets' only notable casualty was the eroding value of the dollar versus other nations' currencies.

As yet, nothing has fallen apart as a result of higher interest rates. During this year's second quarter, market declines functioned to reverse gains booked over the previous quarter or so, and today the stock market stands at nearly the same level as it started the year, yet investors feel jittery. Few investors are taking action; they are simply watching how it all evolves. In other words, if investors see that things are turning out badly, they're ready to sell.

Is this much concern about nothing? I think not. It may simply be a classic lack of motivation among investors to accept a changing status quo. If the recent period was about everybody making money, the next may be more about making adjustments to cope with markets that don't travel in a straight upward line. This is the law of markets – they always

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### Inside This Issue



It is hoped these letters: 1) call attention to the substantial merits of environmentally and socially responsible investing, 2) identify market sectors of under- and over-valuation, 3) report upon those companies that do well by doing good, 4) upon occasion, diagnose an investment vehicle that could become a modest portion of your portfolio, and 5) advise sound investment practices.

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## How Good Are Experts At Predicting Change?

Here we are at a point where leading economists and investment prognosticators are communicating their forecasts with less than their usual degree of conviction. If there is one mistake that Wall Street analysts as a group make time and time again, it is their inability to predict change, particularly during turning points in the economic cycle. And Wall Street experts aren't the only ones whose limitations are well documented.

In Philip Tetlock's recent book, *Expert Political Judgment: How Good Is It? How Can We Know?*, experts were studied as to their abilities to predict events. The results revealed that when experts become too self-confident, they are more likely to be wrong. When experts are locked into narrow considerations, policy dogmas or preconceived notions, as they often are, they're also more likely to be bad predictors.

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Turns out, experts' predictions are no better than those made by the average informed person. In many cases, the more famous the expert, the worse their predictions.

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According to Tetlock, better forecasters are "thinkers who know many small things (tricks of their trade), are skeptical of grand schemes, see explanation and prediction not as deductive exercises but rather as exercises in flexible 'ad hocery' that require stitching together diverse sources of information, and are rather diffident about their own forecasting prowess." In other words, people who read widely, and think independently, are better forecasters of the future than most experts whom the media quotes.

In a similar manner, the apocalyptic experts, i.e. the doomsayers, are always saying that the sky is falling. Eventually they are right but, in the meantime, they are wrong. In other words, doomsayers are ignored until it's too late to profit from their advice.

Perhaps it's time to turn an ear towards these pessimistic "lone wolves", whether or not they may soon be right or wrong. At the least, it's more than ever time to listen to a diversity of voices. ❖

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rise as well as fall.

And over the past several years, and decades, growth-oriented investing has involved far more ups than downs. Perhaps the next era will reward income-oriented investing over growth, or hard assets more than intangibles. These are some of the challenges that we as investors must figure out.

Changes in the market environment are only now beginning to rattle the long-running status quo. The Federal Reserve is hoping that a slowdown in the economy will retard inflationary forces. For those among us who still have faith in the Federal Reserve's ability to save us, I have news. Like the rest of us, they are now watching and waiting to see what happens next. The next course of events may be quite surprising, from the perspective of where we currently sit.

While there are no certainties in investing, the market may be entering a rather dangerous phase where risk-taking "speculative" money may be withdrawn from the market and, like when the tide recedes at the seashore, what lies beneath will be more clearly exposed for all to see. A couple years hence, as the narrative of historical events is told as a backward-looking, unbroken chain of causation, it may all become more obvious.

Add up the trillions of dollars of so-called over-the-counter derivatives manufactured by the world's biggest banks, spiced with the precarious and highly leveraged investment tactics of hedge funds, as well as the easy credit conditions cycling within China's rapidly growing economy, and one can predict a serious problem will develop sooner rather than later.

Here in the U.S., a massive flood of money has swept through the economy in the form of real estate lending, money that the American homeowner cashed out to the tune of $444 billion in 2005. Facilitated by "non-traditional" loan programs that require inadequate fact-checking of borrowers' debts and income (so-called "no income documentation" mortgages), bank loan officers have dubiously created conditions where borrowers may not be able to keep up with their payments.

Further compounding the problem is the popularity of variable-rate, option-ARM mortgages, which require only interest to be paid during their initial years, no payments of principal. Borrowers may be shocked to see how fast their payments rise when introductory teaser rates reset to higher prevailing interest rates. This may be especially problematic for those who borrowed when interest rates were low, during the 2002-05 period. With $2 trillion of ARMs originated in 2004 and 2005 alone, many borrowers have reset dates soon approaching. The early data show that mortgage delinquencies and defaults have begun to rise.

No surprise then that the following problems will be with us for many years ahead: **high debt levels** among consumers and governments, the legacy of **poor budgeting and investing decisions** made by consumers, politicians and investors, and **over-consumption** among American consumers (compounded by high debts, returning to the first of the three highlighted above). And this highlights the advantage of considering sustainability when making investment decisions – what do we really need to buy?

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While stock prices are trading near their all-time highs, it is time to think about the challenges of risk.

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A slowdown in consumer spending would be a serious blow. And the market is figuring out what the prospects are for a recession. Stocks that have done well this year include consumer staples, energy, healthcare and utilities – those that are affected least by a recession. Meanwhile, more economically sensitive sectors of the market such as retail, technology and transportation have fallen.

These days, there is a heightened feeling of uncertainty and, while few are thinking about the depth of the dangers involved, there is this nagging sense that something is different.

Holding a significant position in cash may be conservative but, with cash earning nearly 5%, it's not a bad place to be. If one has to sell some stocks in order to reduce exposure to equities in the overall portfolio, so be it. A prudent investment plan should

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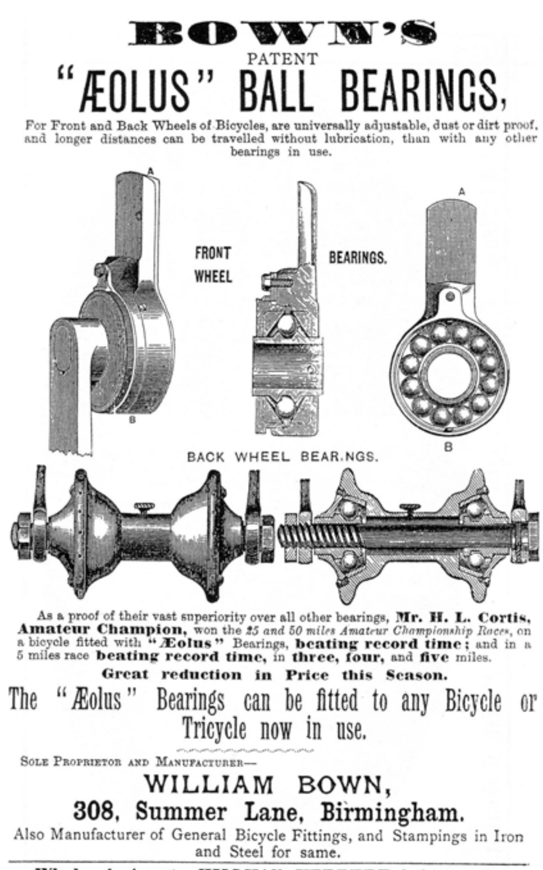
## Cashin' In

Cash is a catchall term for investments that have very short-term maturities, offering the attraction of stable value with interest. Examples are money market funds, Treasury bills, savings accounts and CDs. A couple of years ago, you were lucky to earn 1 or 2% annually on these investments. These days, it's more like 5%. Why hold cash as part of your portfolio?

**Liquidity**: Cash may be held to meet big-ticket spending needs over the near-term. For emergencies, such as the possibility of health problems, losing your job, etc., one might reserve three to six months of living expenses in cash.

**Stability**: Cash is the least vulnerable of assets when it comes to risk of loss. While cash may not earn much more than the rate of inflation, it does protect a portion of the portfolio, reducing the risk of loss should the market decline.

**Opportunity**: By holding some percentage of the total portfolio in cash, it can not only serve as a buffer against tumultuous markets, but it can also enable one to buy stocks during times when they sell for particularly attractive prices. ❖




You use a derailleur when you shift between gears on a modern bicycle. This is achieved by leading the chain from one sprocket to another. Just look where the chain wraps around the sprockets attached to your rear wheel, and there you will find the derailleur, a device that aids in the achievement of forward progress and momentum.

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incorporate such flexibility in responding to prevailing market conditions, without sacrificing long-term goals.

That said, I do suspect that the market will jump around over the near-term, even making impressive short-term gains while Wall Street's experts sort out the changes in progress. This is the time to become skeptical with regard to the long-running trend. Unless you're the kind of person that would feel terrible about being left out of any potential market upswings, let caution be your guide. ❖

| ***Market Data, as of September 1, 2006*** | |
|---|---|
| GDP growth (real): | 3% |
| Inflation (CPI): | 3% |
| S&P 500: | 1311 |
| P/E, trailing (S&P): | 17 |
| 10 year Treasury note: | 4.7% |
| Yield spread (10+ yr. A/BBB corporate bond less Treasury bond): | 1.4% |
| Dollar: | 1.28 U.S. dollar / euro |
| Oil: | $69 / bbl. |
| Gold: | $624 / oz. |
| Consensus for equities (what most investors believe or feel): | Things got a little shaky there this past spring, but the stock market also swings the other way too. A little fear, a little greed make for more than a few money-making opportunities. |
| Consensus thinking on the economy: | Maybe it's not all rosy, but at least it's still hanging together. We may not know where it's all going, but at least we don't think that it's going to be all that bad. |

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*-- Debra Callahan*
*President, League of Conservation Voters*