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HOW MUCH DOES BOARDWALK REALLY COST?

- Murray Sawyer

The financial crisis which brought about our Great Recession had its earthquake moment with the fall of Lehman Brothers in September 2008. In response, Hank Paulson and his Treasury Department and Ben Bernanke and his Federal Reserve immediately sent their fire trucks to the rescue. One of those trucks was a vehicle never employed before to such an extent by the Fed. It was a truck called "Quantitative Easing." Many of our clients and friends have asked for a better explanation of just what that vehicle is and how it works.

The board game Monopoly holds some clues. Imagine you are playing a friendly game with three of your companions. The long-established rules for this Parker Brothers' classic are that each player is given \$1,500 to start the game. Think of that total of \$6,000 as the game's "money supply."

As you proceed around the board, you make informed decisions about whether or not you can afford to buy Pennsylvania Railroad, Vermont Avenue, one of the two utilities and so on. Regardless of your collective decisions, the reality is that you can't buy everything you land on. Choices of whether to buy or not to buy need be made.

In our imaginary game if you spent unwisely or with profligacy before you had the fortuity to land on Boardwalk, then you would not be able to afford its \$400 asking price. You're disappointed. You can either accept that result as one of the outcomes of the rules by which the game is to be played or change the rules.

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Now suppose you and your friends don't like the rule that your money supply is fixed, that it's limited. To remedy that situation you agree that the money to be issued at the start of the game will be \$15,000 per person. With that decision you and your friends, the Monopoly Board of Governors, have just engaged in your own form of Quantitative Easing.

When the Federal Reserve prints money that wasn't part of our country's original money supply, they have done the same thing that you did when you increased the dollars with which you might play the game.

Let's take this a step further. Suppose you change the rules a second time to permit any one of the four contestants to bid on the properties each of you end up on. Now, when Boardwalk is in play, what will happen to that \$400 price?

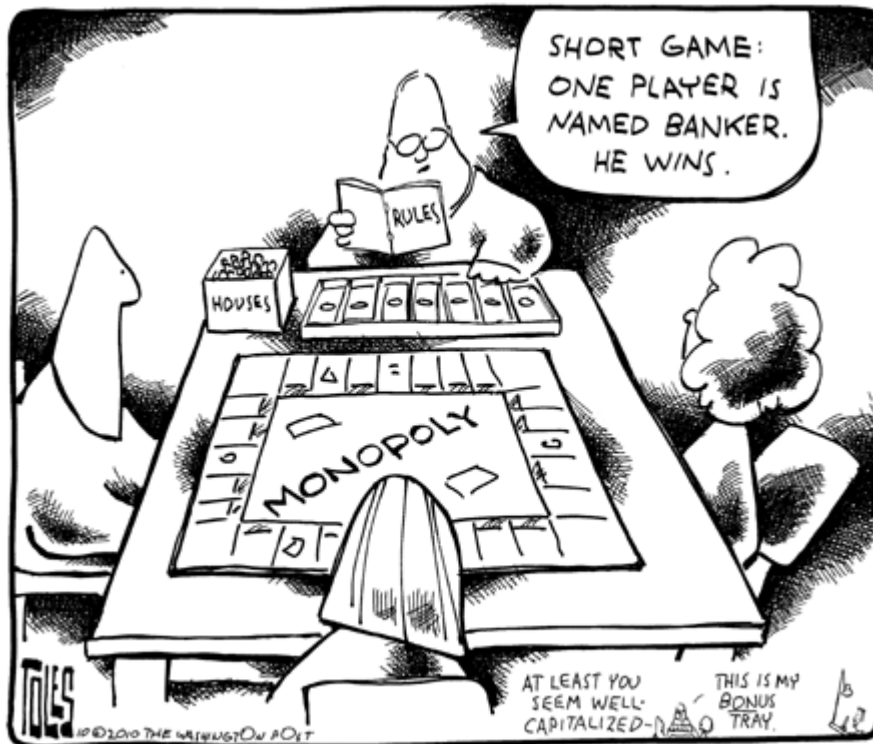
In a bidding war with contestants holding unlimited funds, it will rise. That's what the Fed intended when it bought US Treasury bills instead of Boardwalk with their newly minted greenbacks. They wanted to reflate or increase the price of government securities.

Let's look at the rent or charge our contestants have to pay when they land on Boardwalk. Its \$35. In our Monopoly game playing by the original rules that "yield" or return to Boardwalk's owner is \$35 divided by \$400 or 8.75%. If we assume that in the second game Boardwalk was purchased for \$2000, when money was easy to come by, then the "yield" or interest earned would be less. It would be \$35 divided by \$2000 or 1.75%.

What the Fed hopes is that by flooding the system with free and easy money, yields on the government bonds they bought will fall just as in Monopoly, and that our nation's investment players will then look for other, "riskier" assets offering a higher yield or potential return.

Like stocks.

This philosophy has been helpful to our equity markets. In late August Gentle Ben announced that he and his Board of Governors were considering another round of Quantitative Easing or "QE2." Since then and in anticipation of the implementation of that strategy at its November meeting the equity markets are up 11.5%. Now that's a really good number.



THE MANY METAPHORS OF MONOPOLY
 - Chip Sawyer

Monopoly metaphors are pertinent to today's economic and political environment for reasons even beyond the obvious real-estate theme.

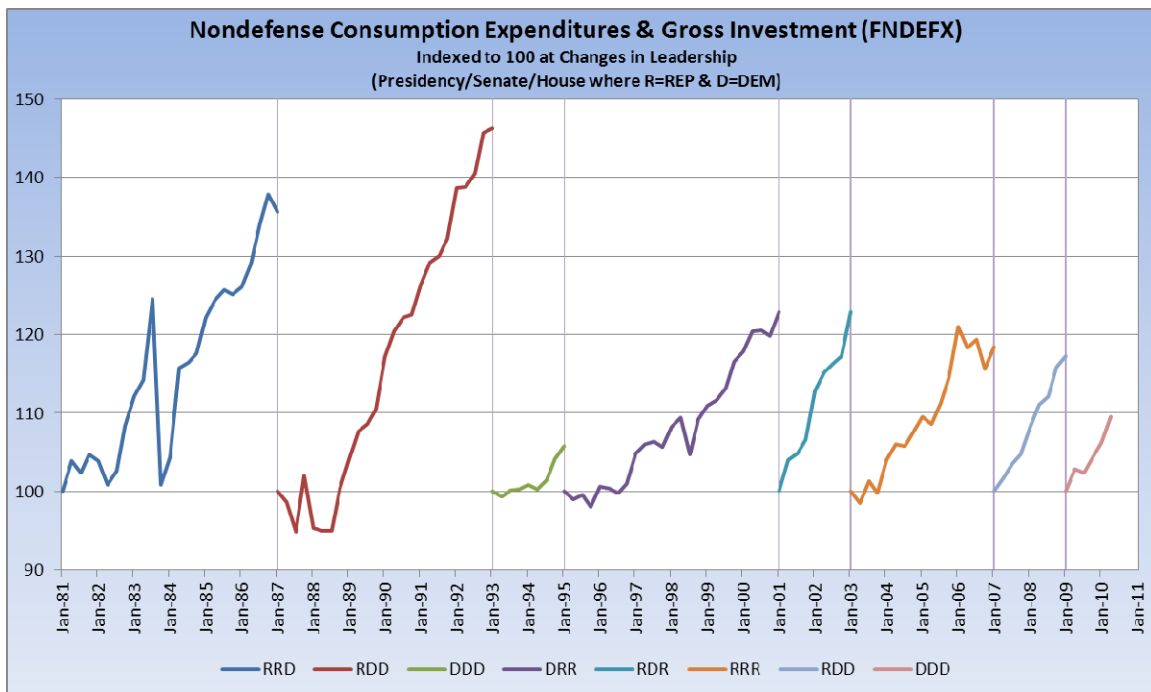
Here's the first. The inventor of Monopoly is thought by some to be Charles Darrow (and the game's own instructions revered Darrow into the 1970s). Mr. Darrow was the laid-off Depression-era salesman who sold the board game idea to Parker Brothers in 1935. It turns out however that the game can be traced to one invented by a Quaker woman named Lizzie Phillips in 1903. That game evolved, with many anonymous people adding changes through the years, into the game whose idea Mr. Darrow sold to Parker Brothers. So, whose game is it really?

This question of "Who should get the credit?" is relevant on many levels today. But in this case "credit" isn't referring to that extended by banks to borrowers (where no one is getting credit as banks and consumers repair their balance sheets). No, in this case, credit is referring to recognition, or blame.

With the election cycle heating up, there has been plenty of rhetoric from both sides blaming the other for any and all problems. Democrats blame the Republican policies of the Bush years, conveniently ignoring the reality that their party has controlled the House and Senate since the 2006 election. Republicans blame the Democrats for "government bailouts," ignoring the reality that TARP was orchestrated by a Republican Treasury Secretary and signed into law by a Republican president.

Here's the second. Government spending has become a hot-button issue; but can either party truly lay claim to wearing the "responsible spending" mantle? The following chart suggests that, like the creation of Monopoly, that credit or blame should be shared.

Since the Ronald Reagan era, regardless of whether a Republican or Democrat was in the White House, and no matter which party controlled Congress, our federal spending has increased. Both defense and non-defense.



Sources: St. Louis Fed, About.com, www.ritholtz.com

Here's the third. Another concept relevant to both the current environment and the creation of Monopoly is that of "unintended consequences."

Lizzie Phillips was a follower of Henry George*. She subscribed to his economic ideology that land should be commonly owned. Her original purpose for Monopoly was to use it to demonstrate the evils of monopolies and to show that rents enriched private landlords while hurting tenants. But after playing Monopoly, I think most would agree that the idea of being the landlord, rather than the tenant, is more attractive.

Today the Fed's persistence in keeping rates low, both in the 2003-2006 time frame and also since late 2008 has led to unintended consequences. Here's one.

Because of certain benchmarked returns they need to make for their constituents, large municipal and state pension funds are now forced to stretch beyond the traditional credit and equity markets to discover arcane, theoretically higher yielding assets. First they invested in timber land and have now followed that up by putting their pensioners' dollars into farmland. Not coincidentally, the price of an acre of Iowa farmland has quadrupled since the mid-1980s. Bubbles are inevitable when interest rates are held artificially low for an extended period of time.

In addition, those same pension funds now face the near impossible challenge of seeking 8% investment returns for their pensioners in today's 2% interest rate environment. And should those funds ever revalue their future obligations in order to accurately reflect the reality of the current low interest rate environment, they will need even greater tax contributions from the cash-strapped municipalities for whom their pensioners work.

Thus the game of Monopoly and its history hold many lessons which have currency today.

Who knows, in order to remain relevant in the 2011 environment, the next change to the game might permit players to borrow 120% of the cost of Boardwalk from the bank.

Another might then also allow those borrower-renters to squat on Boardwalk without paying their rental obligation for 6 to 18 months before facing eviction. Let's just hope the affidavits which accompany the Monopoly eviction papers are drawn more carefully than those which have been drawn against today's real life foreclosure defendants.

*There's even a local community here in Delaware called Arden that follows the tenets of Henry George, including the commonly owned land concept.

WILL HISTORY REPEAT?

- Murray Sawyer

Those who know me realize that this American Studies major is a history buff. In addition to the actions of the Fed regarding Quantitative Easing, here are four historical markers to further suggest that the near term will continue to look relatively rosy for the equity markets.

Riddle me this: Since 1948 if you look at the six month period from November through the following April for the mid-years of the Presidential Election cycles, how many times has it been negative? Hint: The answer is less than one.

That's right. The last 15 times this statistic has been measured, that six month period has **never** been a losing one. The median return for that period has been 16%.

Second, Ned Davis research has discovered that from 1929-2009 the best performing quarter of the 16 quarters of each four year Presidential election cycle has been the 4th quarter of the mid-term election year. That started this past October 1st.

Here's one more: if you went back to 1930 and measured the third year of each presidential term - 2011 for President Obama - those years had an average return of 16.7% for the Standard & Poor's 500 companies. And if you exclude 1931 when the Depression destroyed stocks during President Hoover's third year to the tune of minus 47.1%, then the third year average moves up to 23.8%.

Finally, the strongest market returns for those year-three election cycle measurements have been when there was a Democratic president and a Republican Congress. As it stands today, the prevailing political consensus for 2011 is predicting Republican control of the House and a closer balance in the Senate.

LISTEN TO THE MUSIC

- Murray Sawyer

Dick Christopher, President and CEO of Patterson-Schwartz Realtors, was the winner of our quiz last quarter. He successfully tied the correct singer to the spoofed songs and gave me the actual titles for those ditties. (Six other contestants also made the correct guess, but Dick's submission

was the one we pulled out of our winner's hat).

Fun, Spoofed Titles:

"How Can You Mend a Broken Hip?"

"The First Time Ever I Forgot Your Face"

"I Can't See Clearly Now"

"Fifty Ways to Lose Your Liver"

"A Whiter Shade of Hair"

"Mrs. Brown, You've Got a Lovely Walker"

Correct title and singer:

How Can You Mend a Broken Heart? - Bee Gees.

The First Time Ever I Saw Your Face - Roberta Flack

I Can See Clearly Now - Johnny Nash.

Fifty Ways to Leave Your Lover - Paul Simon.

A Whiter Shade of Pale - Procul Harem.

Mrs. Brown, You've Got a Lovely Daughter - Herman's Hermits.

Since we've spent some time on the significance of mid-year elections to our investment portfolios, let's use that subject matter for our quiz. To all those who are musically challenged, I invite you to participate. You don't even need to know that Katherine Lee Bates wrote "America the Beautiful."

This is for my political junkie friends and those readers who like to make educated guesses about the future.

All 435 voting seats in the House of Representatives are up for reelection. There currently are 255 Democrats, 178 Republicans and 2 vacancies.

Here's the question: What will be the D v. R split come the day after this year's mid-terms elections, November 3rd?

As always, we'll pay a restaurant gift certificate worth \$100 to the person who hazards the closest prediction. And we'll pull the winner's name out of a hat, should more than one of you hit the nail on the head.

Have fun and think twice about the what you think is the true value of Boardwalk the next time someone asks you to play Monopoly!

October 22, 2010