



Excerpts from Quarterly Report written by Investment Partners Asset Management – Q4 2010

Back to School

Graduate schools across the land measure the aptitude of their candidates through a comprehensive examination at the end of their respective programs. Normally a student will dedicate the better part of his or her final semester to recalling the lessons of test cases, class notes, office-hour cram sessions, and general systems understanding to achieve a grade for his or her overall academic performance. The form of the test is usually straightforward: some multiple choice questions, some essays. Each method is designed together to fuse the objective and subjective lessons learned throughout the course of the program. Pass, and get the degree. Fail, and take remedial course work.

Upon completion, the common belief has traditionally been that that graduates have *mastered* the skills necessary to compete and add value to organizations within a complex matrix of the domestic, but increasingly global, economy.

Money for Nothing

Among the specific callings to which we refer is that of Investment Management. Heretofore, the mantras of the manager were well rehearsed; balance and diversify, don't fight the Fed (or the tape); the trend is your friend, etc. Maybe in the past, as long as you were trained to understand supply and demand, free markets, and the principles of money and banking, the investment professional could make more than a day's pay by just showing up - as if the comprehensive course load and examinations were merely hazing stunts – i.e. barriers to entry just high enough to weed out only the truly incompetent.

As we write this piece at the end of 2010, in the face of another great year for the market, we do so with mixed feelings. On one hand, we delight that the year was reflective of the old system of Wall Street. We showed up, and, on the balance, positive market results followed. That we were right for the right reasons or right for the wrong reasons may be of no consequence in the final analysis. The end result was likely an increase in the market value of your securities generally. For that we can all be thankful, and hope 2011 will be a continuation of the Auld Lang Syne typical of the 1990's.

A Brave New World

Unfortunately, this is a new millennium. Markets do not behave as predictably as they once did, and students as well as seasoned money managers are now facing what may prove to be their most difficult case study yet. If we were to treat the present environment as such, what would be some of the assumptions?

- The US Government is engaged in (the second round of) quantitative easing program whereby it issues roughly \$9Bn per day to the Federal Reserve. The Fed then places this additional debt into the hands of primary dealers (the megabanks) who in turn use the proceeds to bolster their balance sheets and speculate in the markets. Everybody wins?
- The Eurozone has a major split among its members between countries who are seemingly bankrupt and those who strive to keep the common currency together.
- Oil, gasoline, foodstuffs, resources and commodities of all types have experienced between a 30 and 100% rise in price over the last year to in some cases unprecedented levels.
- There is a short-term trend toward rising interest rates in both the US debt complex, as well as certain Eurozone sovereign nations.
- There is rampant leveraged excess in both the municipal bond and student loan markets.
- There are *still* overvaluations in some housing markets, and private-property legal quagmires in the US mortgage market.
- We have frothy stock markets with historically high valuations.
- There exists ample (un)employment issues worldwide.
- The gap between rich and poor has never been higher.

After a cursory analysis, even the least sophisticated of money managers would conclude that one or more of these situations, if played out to their logical free market conclusion, could be the catalyst that sparks other stresses on the financial system. Formerly, richly-valued securities prices in such an environment were referred to as “priced for perfection.”

Atlas Shrugs

Currently, as markets have trended higher and volatility has melted away, we seem to have a lop-sided relationship between **Newton’s Law of Motion** (i.e. *a body in motion, tends to stay in motion*) and **Herbert Stein’s Law** (i.e. *if a trend cannot go on forever, it will stop*). Debts and deficits have mounted and continue to be amassed at a geometric rate. The world is seemingly okay with more “money” needed to make the world go around. No one has broken rank....yet....and until now another zero has been tacked on to the escalating tab without much fanfare. Demand is being pulled forward at and seemingly everyone can once again have what he or she wants, when he or she wants it, in whatever quantity desired. This case study isn’t particularly difficult to master, *as long as nothing changes*.

Preventing a win

However, in a complex system where everything is interrelated, the current policy roadmap reminds us of the “prevent defense” in football. This tactic is employed when the team playing defense has a lead and wants to prevent a big play on the part of the offense. Like in football, the markets are being allowed as much leeway as possible to stress the system from all angles, but not allow any one of the fault-lines to actually topple it in its entirety.

To extend the metaphor, the policy of the prevent defense does not always secure victory. In fact, it has often been cynically held that the only thing that the prevent defense actually *prevents* is a win. There are many times, for example, that formations expose a weak link, and the offense takes advantage ultimately winning the game. After all, the idiom “something’s gotta give” still has meaning.

“It” is here and “It” is now” – the so far immortal words of market observer Jim Sinclair

As a result, it may be imprudent to assume that an inferior team with many weak links, playing not to lose, will emerge victorious. In the past, we have referred to the looming catalyst for a market correction as “it.” In other words, “it” can be defined as a) some (negative) market event that occurs due to some unsustainable reality or b) an event that everyone should have seen coming but for whatever reason failed to recognize. Your investment success, and our eventual grade as managers, will be at least somewhat contingent upon our ability to gauge and identify the cause and response to “it” in the future. “It” could assume the form and substance of one of the phenomena listed above, or could manifest in a manner only bounded by one’s imagination. The only *known known* that we have right now is that “it” is out there and with each passing day that momentum moves the markets higher, the probability increases that “it” will arrive.

Not Only the Bad Die Young

If some event or events do transpire that rock the present world financial order, we hope that we may be able to not only pass the exam by being anticipatory. We’ll also need to adjust our world view if needed to capitalize on whatever opportunities may arise in its aftermath. That is why we think that we can continue to serve you well; through flexibility and, hopefully, an ability to plan for “it”. Actually, the prospect of such an outcome is exceptionally exciting to us.

Conclusion

We reiterate; world events are unfolding rapidly. There is a confluence of changes transpiring that will provide a real life, real time, comprehensive examination that could prove to be a doozy – complete with trick questions and interdisciplinary requirements. Grades will not be evenly distributed and success will depend on more than simply textbook knowledge. After managing through 3 market cycles in the past 12 years, we hope to be anticipatory in our management style and to stay at the head of the class.

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