



Good debt versus bad debt

In the First Quarter 2010 newsletter we voiced concerns over debt, regulation and the Fed. Let's look back at the first two quarters of 2010 and review.

Debt: In November 2009, the National Debt was over \$12 trillion. As of this writing, it has now surpassed \$13 trillion, or \$42,000 per citizen. In addition, personal debt per citizen is now estimated to be \$52,000+.

Debt is an integral part of our society and can be used for constructive or destructive purposes.

Good debt is investment debt that creates potential long term value, e.g., student loans, home mortgages and business loans.

Conversely, when you borrow to buy something that declines in value over time, that's bad debt. The purchase of disposable items using a credit card is ok, but only if you pay off the balance every month. If you don't, the goods purchased lose value, while the amount you pay for them is

increased by the amount of the interest on the debt.

When we as individuals fail to observe some of these basic principals, we pay the price. Credit scores fall, we fail to increase our wealth and net worth, etc. In extreme cases, the individual faces bankruptcy and financial ruin.

Government Debt: The unfunded liability for Social Security, Medicare, etc. is \$109 trillion, while GDP is estimated to be about \$14 trillion annually. By the way, the \$109 trillion does not include the \$13 trillion national debt mentioned earlier.

The beneficial effects of these programs are obvious to all of us. Our concern is that they have not been paid for.

In the context of good versus bad debt, these debts are bad debt. Over the past several decades our government borrowed increasing amounts to fund spending that does not increase the long term economic

value of the country. The national credit card debt was not paid off on a timely basis, and the country has now reached its borrowing limit.

When the Dow took a 300 point hit a few weeks ago, the immediate cause was concern over the level of sovereign debt in Greece and other countries in Europe. A streaming video of citizens in Athens rioting the streets to protest proposed wage and entitlement cuts should be a wake-up call to all of us that it is time for the U.S. to fundamentally address its debt issue.

We see only 3 possible solutions to our debt crisis, spending reductions, tax increases and economic growth.

Not surprisingly, economic growth is our preferred alternative. We believe that all government actions (regulations, tax policy, spending) should encourage economic growth, (cont'd page 4)

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Form ADV- Part II

We have updated Form ADV, Part II, a disclosure document that you received when you established your account with GKL. Please contact us if you wish to receive a copy of this update.



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A Market to Like



Ted Levin
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There is little doubt that the economy is slowing. Retail sales are anemic, manufacturing is down, consumer sentiment is plummeting, and it is becoming increasingly difficult for the administration to spin the monthly employment figures.

The bears are clamoring “double dip recession”, while the bulls are arguing that recoveries do not go straight up and that historically there are periods of pause before things get better.

Besides the economy, investors are trying to assess the longer-term effects of some unnerving events from the prior quarter. The “flash” crash came and went without clear resolution to cause. Similarly, so did the European debt crisis. While the worst of the gulf spill is behind us, it is unclear whether Washington will spend the next couple of months determining blame or instead tackle new problems which the private sector cannot remedy.

In spite of all of the above concerns, it appears to us that stocks look inexpensive. Yes, they can get cheaper should we enter a protracted recession. But given low interest rates, no

sign of inflation, and some very early signs of job growth, we are (very) cautiously optimistic regarding the risk-reward opportunity provided by high quality equities.

There is no time in recent history when companies (ex financials) in the S&P 500 have had so much cash – over one trillion dollars. Not only does this bode well for companies should the economy slow, it might encourage corporate managers to increase share buybacks. This maneuver will reduce the number of shares outstanding and increase earnings per share – effectively making the stocks look even cheaper at today’s prices.

Currently, the forward earnings yield on the S&P 500 is 8%. In other words, you expect to receive an 8% return in earnings for one share of stock. When compared to the current yield of the ten year treasury bond, which is 3%, the market looks inexpensive.

Historically, whenever this difference has exceeded 5%, the market gained over 20% during the next twelve months. While we favor looking forward rather than backward when analyzing stocks, it’s hard to ignore this data.

The inverse of the earnings yield (E/P) is the P/E – the more common indicator of stock value. With a current forward P/E of roughly 12, this compares favorably to its long-term average of over 16. (The lower the number the cheaper the stock.)

So why then is the market so inexpensive? Bottom line, we think that the market is unduly pessimistic regarding the long term prospects of the U.S. economy.

While we don’t completely rule out this scenario, we believe that investors are focusing too much on problems here at home and not thinking globally enough. Each year, as more and more of the S&P 500 earnings come from operations outside the U.S. what happens here diminishes in importance. Companies like IBM, Coca-Cola and Intel derive the majority of their business abroad. This trend should continue as BRIC countries, particularly China, continue to grow faster than the U.S. At some point this trend will be too important to ignore. In the meantime we hope to take advantage of these perceived values in the market.

Elephants and animal spirits

What caused this mess?

There is plenty of blame to be shared by many bad actors regarding the causes of the current economic recession, and Washington has pointed its very large finger at Wall Street bankers. This is our first elephant in the living room.

While we believe Wall Street has plenty to answer for regarding its behavior during the past several years, it seems to us that the epicenter of this recession was the bursting of the bubble in the subprime U.S. housing market. The primary cause of this bubble was a multi-decade focus on the part of the federal government to encourage home ownership for low income families, facilitated in no small part by the low interest rate policy implemented by the Federal Reserve in 2002-2007.

Our immediate concern is that the latest regulatory effort (the FinReg legislation) exempts Fannie Mae and Freddie Mac and provides a great deal of as yet undefined regulatory power to the same regulators and agencies who fumbled the ball in the first place.

Are we fixing the problem?

Trillions of dollars have been spent in various bank bailout and stimulus programs, the Fed has reduced short term interest rates to virtually zero. At best, the overall economy and unemployment are not falling any more. The “V” recovery has not arrived.

The second elephant in the room, in our opinion, is that these strategies are not working, at least not as well as they should, given the magnitude of the effort. Perhaps debt-funded stimulus is not that effective, and maybe 0% interest rates are dangerous.

Animal Spirits

John M Keynes (the author of “Keynesian” economics) discussed the impact of animal spirits on the performance of the overall economy. Another word for this is **confidence** on the part of both consumers and businesses.

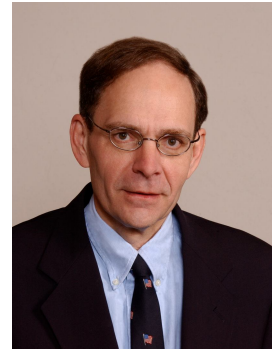
We believe that the lack of confidence is the single most important factor holding back the economic recovery. The good news is that corporations and banks have literally trillions of potentially investable assets, and interest rates are at record lows.

The bad news is that the anti-business rhetoric and actions emanating from Washington are enormously damaging to business confidence. The unknowns associated with the health care and FinReg legislation have added to overall business uncertainty. The regulatory environment is expected to be increasingly hostile to business, especially banks, and tax legislation is a complete unknown at this point.

Investment Implications

Bottom line, stick with high quality, dividend paying equities, avoid bonds, and keep some cash on the sidelines for potential opportunities.

Tom’s comments regarding debt are on target, but perhaps paradoxically should give the reader some reason for optimism. For the first time in our lifetime, the American people may be willing to make hard decisions regarding government spending at all levels. In addition, Ted’s comments regarding valuation suggest that the market will react quite positively if we can meaningfully address our problems.



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Good debt versus bad debt (cont'd)

not discourage it.

As for taxes, we agree with the comment that paying taxes is the price we pay for a civilized society.

Our concern with tax increases is that people don't work or invest to pay taxes. They work and invest to earn after-tax income to provide for their families well being.

When you want less of something, tax it. The risk of tax increases is that we will get less investment, less productivity and less economic growth.

As for spending cuts, we acknowledge that everyone is in favor of this solution...for the OTHER guy.

At a minimum we encourage the reader to review Paul Ryan's "Road Map For America's Future." Congressman Ryan is one of the few politicians who is willing to honestly address the very difficult economic decisions with which we are faced. We can agree or disagree with some or all of his proposals, but we need to have the dis-

cussion and reach some decisions.

The current environment in Washington is dysfunctional. Until sound business principals become common in Washington, the probability of demonstrations ala Athens occurring in the U.S. increase over time

