The 70% Solution

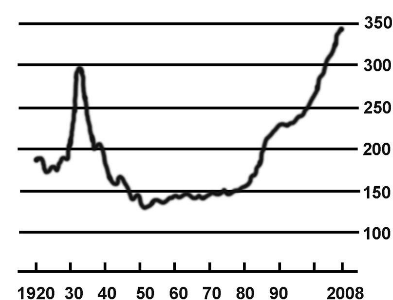
Shifting the risk-reward ratio in your favor

Managed Sector Fund Investing

October 24, 2008

The Great Debt Crisis of 2008

The handwriting has been on the wall for a long, long time. Admittedly, it was impossible to predict exactly when disaster would strike. It is also impossible to accurately predict all the economic problems still ahead. While specifics may be elusive, the foundation for a serious financial disaster was being laid at least a decade ago. Economic growth had been fueled primarily by a disproportionate growth in debt ever since Ronald Reagan took office, but it is only in the last decade that the ratio of total US debt (public and private) to economic output rose to well above the average of the prior ¾ of a century. A similar, private sector debt-fueled boom led to the Great Depression. A few years into the depression, bankruptcies wiped out the excess debt. Those bankruptcies ushered in a half century of relatively conservative lending practices keeping the ratio of debt to GDP relatively constant. Although the chart to the right only shows the numbers through the 1st quarter of 2008, total debt is already contracting as banks book losses and homes are lost to foreclosure.



Preventing or limiting recessions with interest rate cuts maintains the excess leverage in the system. However, once economic output peaks, additional credit creation only generates inflation. It is this phenomenon that ends the game. There are only two options, see living standards decline as inflation moves higher and higher, or see living standards decline as a result of recession. Neither choice is politically acceptable in the short term, but accelerating inflation is more destructive in the long term. Recessions correct the short term excesses, and improve the long term outlook. This works reasonably well when the debt to GDP ratio is in the 100-200% range. The higher the debt ratio, the greater the potential for a severe or protracted recession. The recessions in the 1970s and early 1980s and early 1990s were more severe or longer than the recessions in the 1950s and 1960s.

Surprisingly, the Reagan presidency marked the beginning of exponential growth in US Debt. Even the massive government borrowing used to finance World War II and the entitlement programs of the Great Society were dwarfed by the expansion that has occurred in the last 30 years. US Government debt grew faster in the 1940s and 1960s, but growth in private sector debt in the last decade dwarfed those numbers as well. Corporate borrowing during the Clinton administration and mortgage borrowing during the Bush years were astronomical.

According to Federal Reserve data, federal government borrowing outpaced economic growth by less than 10% while state & local borrowing like (non financial) business borrowing grew 60- 65% faster than GDP. Banks and households were the real culprits. Household borrowing expanded almost twice as fast as the economy and the banks increased their debt even faster. The shocking truth is that only the Federal Government can stem the tide. They are the least leveraged segment of the economy. And only they can print money. The government credit expansion is not likely to be inflationary as long as private sector debt contracts rapidly. Contraction of private sector debt without the offsetting government action could result in another depression. The long term unintended consequences will be costly. While expansion is necessary in the short term, government is unlikely to stop when the private sector stabilizes and the government faces the unfunded liabilities of Social Security and Medicare.

Americans borrowed their living standard from the future. It's payback time and we don't have the money. There is only one way to balance the books. Americans as a whole will lower their standard of living by postponing retirement.

A Publication of Financial Solutions Group, LLC **Clyde E. Kendzierski, Editor**
6700 E Pacific Coast Highway, Suite 291, Long Beach, CA 90803 (562) 430-2223
www.financial-solutions-group.biz clyde@financial-solutions-group.biz

What is The 70% Solution?

This newsletter was named after a diversified investment program for managed accounts. That program seeks to capture 70% of the gains of a rising stock market and avoid 70% of the losses when the market declines. It is intended for clients who desire long term investment returns similar to the S&P 500 Index, with reduced volatility. The program was originally designed for qualified plans such as retirement accounts and certain trusts (some taxable accounts may be unsuitable). We invest in industry specific, sector mutual funds. We never purchase individual stocks although on rare occurrences we will invest in industry specific Exchange Traded Funds. The diversified portfolio only invests in sectors that meet our proprietary criteria for being relatively undervalued at time of purchase. Most of the funds are part of the Fidelity Select family. Although this program is designed to reduce short-term volatility, we advise against investing in this or any other equity program for less than three years. Unlike market timing programs, this diversified investment program is rarely 100% invested or 100% in money market funds. We also offer an aggressive program for investors comfortable with very volatile investments as well as a fixed income program for more conservative investors. As with any investment program, past performance does not guarantee similar future results.

Investment opinions expressed in the newsletter are based on the analysis of Clyde E. Kendzierski, a Managing Director and Chief Investment Officer of Financial Solutions Group, LLC. Financial Solutions Group, LLC is an Investment Advisor registered with the Securities and Exchange Commission. Mr. Kendzierski is also a registered investment advisor and holds a Masters Degree in Economics. Since the mid-1970's he has been employed by major California banks as a money manager and bond trader, managing accounts as large as 1.7 billion dollars. Following the largest municipal bankruptcy in history (Orange County, California), he was appointed to the Treasury Oversight Committee to establish investment policies to prevent similar debacles in the future. He created the 70% Solution investment program in the early 1980's for management of his personal retirement funds.

Managed accounts generally reflect the results of the model portfolios published in the newsletter. Individual results reflect the client's unique mix between the diversified, aggressive and fixed income strategies (adjusted for fees, which vary with account size). The program is offered through NASD registered broker-dealers. Clients' funds are held in custody at a subsidiary of Fidelity Brokerage. The Advisor is given limited trading authority, but never takes possession of client funds.
*Financial Solutions Group, LLC publishes *The 70% Solution* newsletter, plus special Investor Alerts.
*If you have received this newsletter in error or would like to be removed from this mailing list, please contact chris@financial-solutions-group.biz with the subject "Remove" and allow 10 business days to process your request.

Financial Solutions Group LLC
6700 E Pacific Coast Highway
Suite 291
Long Beach, CA 90803