

The logo for PASI NEWS features the word "PASI" in a large, bold, blue serif font. The letter "A" is stylized with a white swoosh that curves around its right side. To the right of "PASI" is the word "NEWS" in a smaller, blue, italicized serif font. Above the "SI" part of "PASI" is the text "since 1977" in a small, blue, sans-serif font. A horizontal line runs across the page below the logo.

since 1977
PASI *NEWS*

Volume 35 - Number 2

Summer 2011

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Market Update: *What's Really Important*

By: David A. Jaffe, M.D.

On occasion my dad used to take the liberty to write a personal column for our newsletter about recent travels or an interesting experience he thought worth sharing. With that precedent I thought I'd deviate from the usual "market update" and relate an adventure from which I've just returned. After all, I can't help but wonder how many different ways you want to read about turmoil in Europe or unemployment in the U.S. or our dysfunctional political system flirting with default on U.S. debt. Instead, how about two weeks out in the woods?

Founded with an initial gift from Oklahoma oilman Waite Phillips in 1938, Philmont Scout Ranch in Cimarron New Mexico represents the pinnacle of "high adventure" for the Boy Scouts of America. The ranch now encompasses 135,000 acres of pristine wilderness, the features of which range from lush green meadows ideal for grazing cows to rocky spires including the iconic *Tooth of Time*, a cuspid-shaped peak which punctuates the mountainous vistas seen from base camp.

Our "trek" was typical, eight scouts and four adults. The boys ranged in age from 14 to 17, the adults dubbed "the old guys." We would be hiking in the Philmont Backcountry for 12 days, covering approximately 75 miles at elevations ranging from 6,700 feet to a peak of 11,740 feet. The scout ranch would provide trail meals at the beginning of our trek with resupply on days 5 and 7. We must otherwise be self-sufficient for our time in the woods.

Preparation focused on two key areas: fitness and gear. We knew the trek would be physically demanding. Participants chose the training that suited them; some arrived better prepared than others. Required gear was more straightforward – clothing and shelter to accommodate days in the 90's and nights in the 30's (with a good chance of rain), group cooking, personal hygiene, navigation, and first aid. The challenge was to be adequately prepared while choosing only the absolute essentials, and then cutting every possible ounce of weight from the load that we would ultimately carry on our backs. I packed and repacked at least a dozen times, and the boxes from Amazon kept on coming, much to my wife's consternation.

After weeks of anticipation we were off to Albuquerque where our adventure started with a 2-day "pre-trip", visits to Pueblo cliff dwellings and a rafting excursion on the Rio Grande River, but most importantly, a 48 hour head-start on acclimation to altitude before beginning our trek. Delivered to Philmont Base Camp on day 3, we navigated a maze of paperwork that made me imagine an army boot camp run by Bahamian Immigration. We finally settled in our temporary quarters and met "Ranger Christian", a 20'ish y.o. mountain man who we soon learned could squat in the lightening position for hours if need be. Christian

was to be our teacher and guide for the first 2 ½ days in the backcountry, later to set us free if we were deemed worthy.

After clearing headquarters, medical, logistics, security, commissary, and crew equipment, we were subject to a final shakedown where our Ranger identified another 20% or so of our gear which could be left behind (one tube of toothpaste will suffice for the entire crew for 12 days, right?). The following morning we savored our last fresh food and hot showers, loaded up our packs with five days of dehydrated food and 4 liters of water (my 32 pound pack left base camp weighing 49 ½ pounds), and boarded a school bus for our starting point, the Rayado Turnaround.

Philmont camps are divided between *staff* and *trail* camps. Staff camps typically follow a theme, and include permanent support staff who live at the camps and offer one or more programs. Staff appear in period dress and greet visitors “The year is 1912 and you’ve arrived at Cypher’s Mine.” Luxuries at staff camps include potable water, fresh fruit, and advisor’s coffee at 7PM. Trail camps are Spartan, equipped with cables for bear bags, fire pits, a sump for food waste, and a basic latrine or *Red Roof Inn* (more later). Water, if available, must be filtered or treated.

Rayado was a typical staff camp, and the boys got a turn at Tomahawk throwing and Blacksmithing. We ate lunch under the trees while Ranger Christian taught map and compass skills and reviewed Philmont policies and procedures. Beginning the hike to our first overnight, Christian called a meeting to introduce the Red Roof Inn, and thirteen of us squeezed into an enclosed latrine with a red metal roof where we learned the importance of checking for spiders before taking a seat.

Our first night was spent at a trail camp, and getting settled reminded me of the first day in my medical office, when I was wisely advised to schedule only *one* patient for the entire day. Chores which later became fluid and routine were at first daunting –setting up our tarp, sterilizing dishes, fetching water, and preparing for dinner. Paramount were precautions regarding “smellables”, anything from food to toothpaste, Gold Bond powder, and our precious ChapStick (prohibited after 5PM). We were soon educated regarding the amazing sensitivity of a bear’s nose – even seemingly inert devices such as cameras and ball point pens were to be stuffed in a smelly boot before bed. Philmont takes their bear precautions very seriously. All smellables are hoisted off the ground in bear bags, so that even our 6’2” linebacker crew leader could not touch them with a running jump. Dishes go by the sump, and water bottles in the fire pit. That’s the Philmont way. Remarkably, after 11 nights in the wilderness, we never saw any hint that even a curious squirrel had disturbed our gear, which led our boys to declare on exit “there are no bears at Philmont.” Other crews know differently.

Whether good fortune or good procedures, we were never threatened by the wildfires that spread through Arizona and New Mexico in the weeks before and after our visit. The southwest was suffering from a severe drought; we were informed on arrival that Philmont had received a scant one-half inch of rain in the six months prior to our visit. We were not allowed any campfires, and usually reliable water sources were suspect. While we were able to pump cold clear water from a bubbling creek at our first camp, our second night we were introduced to “green water” and the miracle of Micropur tablets. About 200 yards up a hill from our campsite was a tank resembling those oil storage facilities that dot (some of) the New Jersey landscape, only on a smaller scale. And drinking out of the New Jersey tanks would probably have been more appealing. Still, while colonies of green algae floated on top of the water tank, opening the spigot located midway down the tank yielded relatively clear water. One Micropur tablet per liter, 30 minutes wait time, and the chlorine scented water was declared safe to drink. As of this writing, none of our crew has reported symptoms of Giardiasis (another week before we can safely declare that we’re “out of the woods” on that count).

Our last morning with Ranger Christian was magical. After a surprise treat of pound cake at dinner accompanied by a can of Betty Crocker icing (which the boys were *forced* to finish or pack out), Christian

announced that he planned to awaken us at 4:30AM to experience the sunrise. The next morning we trudged out in our pajamas and settled on a rocky ledge with an expansive view of a valley below, ringed by mountains. For a few minutes it was absolutely silent, and then ... one bird started singing. As though awakened by the first interloper, others started singing and within minutes we were treated to a cacophony of birdsong. As the light crept into the valley below and up the mountain ridges, we heard an eerie call that Mountain Man Christian declared without hesitation was the awakening of a mountain lion, a rare encounter.

After one more refresher on map and compass skills, our Ranger let us loose with trepidation that turned out to be well justified. Our goal that day was a modest hike to a staff camp known as Miner's Park, where the boys could go rock climbing and the adults enjoy hot showers. After another visit to the green water tank and several false starts looking for the proper trail, we hiked about 2 miles to a meadow where we encountered a crew from Baltimore being led by a very confident young "naviguesser". Consultation with our leader du jour led to discovery of a "short-cut", and we marched on up a dirt road (Ranger Christian: "never take the roads – they're dusty, steep, and hard on your feet"). An hour later, hot and tired, our misadventure rewarded us with a beautiful view of the Tooth of Time in the distance ... but none of the expected landmarks appeared. Retracing our steps back down the road, we verified our location (passed a waiting water source) and headed confidently *down another dirt road* in the direction of Miner's Park. Several unplanned detours and a few hours passed before we finally trudged into camp, late and almost out of water, to find Ranger Christian waiting for us on the porch. He'd been there since 10:30AM ... and he was worried.

Yes, we did learn from our early mistakes, and things got better every day. We took advantage of any available clue in navigation ... location of streams, compass bearings, sighting peaks and valleys, and we discovered that an altimeter watch was more than just a toy, using elevations and contour lines to confirm a point on a trail. We never passed an available water source again without filling up. The boys learned to pitch camp like clockwork, dividing chores on a work roster, even setting up the tent for those assigned to the night's cooking.

In the blur of activities, highlights included blowing holes in our bandannas and wallets with black powder rifles, branding anything that could be branded (boots, hats, Crocs, plastic bowls), an endless array of junk food breakfast and lunch items (Lara bars, Cliff bars, Mojo bars, Quaker oatmeal bars, Stinger waffles, sunflower butter, pilot biscuits, trail mix ... the list goes on and on), dehydrated dinners that were always too dry or too soupy, straining tadpoles out of our drinking water, and seeing my son Elliot's delight beating a staff member in a Tomahawk throwing contest (his prize, a cold vanilla pudding cup). And always there was the natural beauty. The stars literally popped out of the ink black sky at night, the Milky Way a cloud above us. In the morning a Mule Deer or young buck would casually traverse our camp as we sat sipping coffee. The mountain vistas were unending. As were the bad jokes and worse puns.

The irony is that the smoother we worked together as a team, the faster the days flew by. One of the few significant challenges occurred on day 10. After a beautiful and easy 3 mile trek in the woods, following a clear stream to that evening's camp, there was a great deal of trepidation among a contingent of our crew regarding the next day's hike. Judged by some as the most difficult at Philmont, we were scheduled to summit Mt. Phillips, leaving our current camp at 10,400' and ascending to a peak of 11,740' before a gentle descent to that night's destination. An alternative route would skirt Mt. Phillips, a longer but easier course. Hearing discussion of our dilemma at Advisor Coffee, a staff member declared that we *must* experience Mt. Phillips, and enjoined our crew with a pep talk and coached strategy, including the boys dividing the gear of two concerned crew members to lighten their loads. The boys took charge, the pace was perfect, and we arrived at the top of Mt. Phillips in unity and good spirits. We worked together, and it was easy.

The last day was the toughest. The trail broken and uneven, littered with large rocks. We stopped for lunch at the base of the Tooth of Time and climbed that 400' pile of boulders to the peak (without packs), each of us taking a different route as there was no trail. At the top we were treated to a beautiful expansive view of

northeastern New Mexico, visibility probably exceeding fifty miles. Mentally the Tooth of Time was the pinnacle and it was quite literally all downhill from there. But the final leg was an endless series of switchbacks with intermittent views of our destination, which never seemed to get closer. No wonder that path is known as the Philmont “Trail of Tears”. We hiked 13 miles that day, and we all felt it.

Return to base camp meant bathroom facilities and fresh food and iPods and cell phones. While the hot showers felt great and even the shoe leather pork chops were delicious, the return to civilization for our unified crew, so recently bonded in the wilderness to facilitate our survival, was abrupt and surreal. At the closing campfire, Philmont staff predicted that we would try to explain our experience to others, and that try as we might it would be impossible. I’m sure that’s true, but in writing this piece I’ve relived it a bit myself, and I hope that I’ve captured some of the essence for you.

As you’re well aware, civilization did not end while we were sequestered in the wilderness. The stock market did not crash. Reluctantly viewing the news after two weeks of isolation, I discovered that little had changed. Ending a six week market decline with a strong rally in late June, the S&P 500 gained a mere 0.10% for the second quarter, including reinvested dividends. The previously unloved quality companies of the PASI portfolio garnered favor in the volatile quarter, surging 3.36% and edging ahead of the S&P 500 for 2011 posting a YTD return of 6.14%, vs. 6.02% for the benchmark index.

The dominant worry for investors today seems to be the debt ceiling limit. The game of political chicken between Democrats and Republicans has been turned on its head, a challenge to see who will compromise more and who will cut more (into the national debt, that is). It’s almost like there may be an election battle brewing for 2012, but I don’t want to be so cynical as to suggest anyone would put their political agenda ahead of an issue so important for the future of our country. We’d be willing to bet there will be an 11th hour resolution, and the financial markets, taking things in stride, seem to agree. Still, why not save \$1 billion plus in campaign expenses and just resolve the conflict with a good old-fashioned tomahawk throwing contest? Best two out of three wins.

Slowly, Then All at Once

By: Nathan Polackwich, CFA

It is October 1931. The U.S. is already mired in the Great Depression with the economy having contracted 15% over the previous two years. Short-term interest rates are 1.5%. What does the Federal Reserve do? They hike rates a percentage point to 2.5%. In November, they raise rates again to 3.5%. The higher short-term rates are the last straw for an already teetering U.S. banking industry. In October alone 522 banks fail. The Depression accelerates. In 1932 the U.S. economy contracts another 13%. What in the world was the Fed thinking?

The Fed had no good options. At that time U.S. monetary policy (as well as the monetary policy of most developed countries) followed the Gold Standard. Under the Gold Standard paper currency issued by the Federal Reserve was convertible into gold at a fixed price, and thus the supply of money was mainly influenced by gold discoveries and flows due to international trade.

This is all fine and good in a growing economy, but the Gold Standard's central flaw becomes glaringly obvious in a financial crisis – it acts as a straightjacket for monetary policy. Specifically, many investors/speculators, fearing for the safety of their currency holdings (due to the possibility of a currency devaluation as well as bank failures), will choose to redeem their money for gold. As the central bank's gold reserves drop, so too must the money supply.¹ In the middle of a depression this is a disaster – less money

¹ At that time the Federal Reserve was required to have 40% gold backing of the currency in circulation. So lower gold reserves meant less money in the economy.

slushing around the economy means lower wages and profits, which makes it increasingly difficult for households and businesses to repay their debts. This leads to more defaults, more economic weakness, and more people demanding to exchange their currency for gold.

To stem the decline in gold from its coffers the Fed had just one policy tool – raising interest rates. Higher rates provide an incentive for people to keep their assets in dollars (they earn more in interest). In this the Fed succeeded. But while they won the battle they lost the war, as higher rates caused hundreds of bank failures and arguably damaged the economy more than had the Fed done nothing.

Today the Euro is constraining a number of struggling European economies (particularly Portugal, Ireland, Italy, Greece, and Spain – collectively known as the PIIGS) in a manner analogous to that of the Gold Standard during the Great Depression. In fact, these countries are already enduring Great Depression-like economic slumps with no end in sight and a complete inability – because of their membership in the Eurozone – to stop their economies from spiraling into oblivion.

Monetary policy in the Eurozone is handled by the European Central Bank (ECB), which is dominated by France and Germany. The PIIGS' problem is that the monetary policy they need to extricate themselves from their depressions is at odds with the monetary policy desired by the stronger members of the Eurozone, particularly Germany.

Germany is a manufacturing machine, with large trade surpluses and savings rates. Its consistently massive trade surpluses indicate that the Euro for Germany, given the high productivity of its workers, is too weak. Conversely, the consistently wide trade deficits and low savings rates of the PIIGS suggests that for them the value of the Euro is too high. Yet because they're both members of the Eurozone, this structural imbalance persists year after year with German savings and, conversely, PIIGS' debt levels, growing ever larger.²

If the PIIGS and Germany each had their own currencies this imbalance would naturally be resolved by a significant depreciation of the PIIGS' currency (relative to both Germany and much of the rest of the world). What would a much weaker PIIGS currency achieve?

1) The PIIGS domestic production of goods and services would become more competitive price-wise both globally as well as within their local economies. With an improved climate for domestic production, the PIIGS' would see their trade deficits fall, employment rise, and government budget deficits shrink (more tax revenue from higher wages and profits and lower expenditures on things like unemployment compensation).

2) The PIIGS debt levels would immediately become less onerous. Say Greece was on the Drachma (their old currency) and the Greek government owed German banks 50 billion Drachmae. If Greece devalued the Drachma by 50%, suddenly the real value of Greece's debt to Germany would also drop 50%. Of course, a 50% devaluation would be inflationary, as it would make imports twice as expensive. And in most cases, inflation is an impediment to economic growth. But when a country owes more than it can ever hope to pay back, default or inflation (technically, a form of default) is the only way out.

Germany and the stronger members of the Eurozone, of course, adamantly oppose a significant depreciation of the Euro. With German manufacturing humming and unemployment at just 6.1 percent (the lowest since 1992), the Germans fear inflation, not economic stagnation. In fact they want to *raise* interest rates to keep the Euro strong and inflation weak. For the PIIGS, the effect would be no different than the Fed's interest rate hikes during the Great Depression.

² The U.S. and China share a similar structural imbalance thanks to China pegging its currency, the Yuan, at an undervalued rate relative to the dollar.

So the PIIGS are stuck. Their economies are severely depressed and will remain uncompetitive until wages fall significantly nationwide (either through a currency devaluation or years of crushing depression and politically unstable levels of unemployment). Their depressions plus relatively profligate government spending³ have resulted in enormous budget deficits and rapidly mounting debt levels. As members of the Eurozone, the PIIGS governments can't just print money to pay their bills (as countries which control their own currencies like the U.S., Japan, the U.K., and China can). To spend money they must first go hat in hand to the credit markets to borrow. But investors have rightly concluded that the odds of these countries having the capacity to ever repay their debts is basically zero. So interest rates on the PIIGS' bonds have skyrocketed, only adding to their budget deficits and overall debt burdens.

Over the past year only European Central Bank loans (bailouts) have kept the PIIGS from defaulting. The bailouts have taken numerous forms including direct loans to PIIGS' governments as well as loans to the PIIGS' banks in exchange for collateral of dubious quality. As an example of the latter, Greek banks own a lot of Greek government bonds. These bonds trade for around 55 cents on the Euro (they've lost 45% of their value). Thus, the Greek banks are effectively insolvent. Mercifully, the ECB has loaned the Greek banks money in exchange for their Greek government debt, paying them 100 cents on the Euro. Overall, considering the loans to both PIIGS' governments and banks, the ECB has already ponied up about 444 billion Euros (\$640 billion). And the PIIGS owe *a lot* more to private investors across Europe and even the United States.

In return for these bailouts, the ECB is demanding harsh austerity from the PIIGS' governments. But austerity is counter-productive in a depression. The more they cut spending, the more their economies contract, and the more tax revenues they lose. Thus, the effect on their budget deficits is minimal. Meanwhile, their debts continue to mount.

Under the current regime, the only way the PIIGS can avoid default is if the Germans keep lending their governments and banks hundreds of billions of Euros year in and year out with no prospect of ever getting their money back. Will German citizens accept this? Will the PIIGS' citizens accept endless depressions and unemployment? How long can the ECB continue to kick the can down the road with more and more pointless bailouts?

It's possible that the PIIGS and stronger countries of the Eurozone will decide to become a more unified country (a transfer union), similar to the structure of the United States where both monetary *and* fiscal policy is handled by one governing body. In that case the Germans would no longer have to lend Greece money – they would directly subsidize Greek public spending as well as guarantee Greek and the other PIIGS' enormous debt. But again, will the German people really willingly hand over their savings to the PIIGS? And will the PIIGS' citizens willingly surrender their fiscal sovereignty to the Germans? It's not inconceivable. But the cultural differences are so vast I have a hard time imagining how such a scenario could happen.

Ernest Hemingway once described how people go bankrupt as, "Slowly. Then all at once." I imagine the PIIGS' inevitable default will unfold similarly. Eventually, one of the PIIGS governments or the German people themselves will say, "enough." A default by one of the PIIGS will cause a panic in other troubled European economies and a chain reaction of further defaults. To keep their banks from failing PIIGS governments will be forced to nationalize their banks, forbid withdrawals (to stop bank runs), and return to their old currencies which they'll immediately devalue.

This process will undoubtedly be traumatic for the financial markets. But in the long-run it will be good news. The worldwide abandonment of the Gold Standard in the early 1930s is what ultimately ended the

³ Greece's government has generally been the most profligate. Ireland's enormous budget deficit was greatly exacerbated by the Irish government's decision to honor the debts of its failed banks. Italy, Spain, and Portugal's deficits and debt mainly reflect the persistent weakness of their economies.

Great Depression. Of the 14 countries that left the Gold Standard in 1931, for instance, every single one generated positive growth in industrial production from 1932 on. The U.S. (effectively) left the gold standard in early 1933. Not coincidentally, that's when the U.S. economy finally began to recover. Also of note – countries that never followed the Gold Standard largely avoided the Great Depression.

When people tell me they fear the U.S. dollar is going to crash, my question is always "relative to what?" The Euro is likely to unravel. Japanese government debt levels are among the highest in the world as a percentage of their GDP. Between their rapidly aging population and ongoing nuclear tragedy, the Yen is certainly a currency I'd avoid. How about emerging market currencies? As we've discussed in prior newsletter articles, China's investment bubble is arguably the biggest in history. And other developing economies are highly dependent on China's insatiable demand for their commodities. Will these countries' economic "miracles" continue once the China bubble pops? I'm not so sure.

The U.S. budget deficit is out of control, but we won't have a debt crisis like Europe because, as noted above, unlike European countries we can just print money to pay our bills.⁴ That means inflation, not default is the risk we face. But with unemployment stubbornly high, U.S. households still way over their heads in debt, and bank balance sheets too weak to aggressively lend, significant inflation is unlikely for the time being. Additionally, among the developed world and even China, U.S. demographics are among the most favorable (plenty of young people and continued population growth). So the U.S. remains the best house in an admittedly bad neighborhood. We expect it will prove the safest place to ride out the storm in Europe.

Who's Chicken?

By: Chris Steele, CFP®

Brinkmanship is the art or practice of pushing a dangerous situation or confrontation to the limit of safety especially to force a desired outcome⁵. It's a common strategy seen in political debates, like the current talks regarding the U.S. debt ceiling.

The debt ceiling is a cap set by congress to limit the total amount of money the federal government can borrow. At the end of fiscal 2010 the federal debt was approximately \$14.1T, with the debt ceiling standing near \$14.3T and expected to be breached around August 2, 2011. The Treasury has told lawmakers that a \$2T increase is needed to last through the 2012 elections.

Republicans are looking for \$2.5 trillion in spending cuts (including Medicare) and no tax increases. Democrats want to leave Medicare untouched and increase revenues through tax increases like repeal of LIFO (last-in, first-out) accounting for businesses, cuts in subsidies for oil and gas companies, caps on tax deductions for people making over \$1 million per year, and ending ethanol subsidies and corporate jet tax breaks.

Since its implementation in 1917, Congress has never failed to raise the debt ceiling. A compromise of some sort would be the most likely outcome. The Democrats have already agreed to over a trillion dollars in spending cuts and want to see the remainder come from tax increases. The Republicans could meet those spending cuts with some of the narrow tax cuts requested by the Dems to ensure America doesn't go into default.

In the unlikely event the ceiling is not raised, the Treasury will be responsible for deciding who does and doesn't get paid from our daily cash flows since those will be the only monies available. In this scenario it

⁴ Even if Congress fails to raise the debt ceiling they'll still have plenty of money to repay their debts – spending will be cut elsewhere, though another recession would most likely result.

⁵ Merriam-Webster Dictionary

would be highly probable that active military, federal employees, Medicare/Medicaid, Departments of Justice, Labor & Commerce as well as benefits and welfare in some combination would not receive any funding or pay.

What would happen to financial markets should the U.S. default is extremely speculative. The extent of the actual damage would depend on how long Congress failed to act. Most likely the dollar would collapse, interest rates would spike, and stock markets would sell-off in the short-term. The high quality businesses owned by PASI clients would be impacted but not permanently damaged by a brief default, and we are currently sitting on a little extra cash.

Some have estimated that an extended halt in government spending would precipitate a 9% decline in GDP, a worse outcome than the 2008-2009 recession. This is exactly why none of our leaders who value their political futures will let this happen. There is a growing belief that the President could mandate payment by the Treasury based on the 14th Amendment declaration that “the validity of the public debt of the United States shall not be questioned”. The closer we get to the deadline the more each party will dig in their heels to try and claim victory in this political game of chicken. Hopefully, the American taxpayer won’t end up as the turkey!

Why Does it Look Like I’m Losing Money on My Bonds?

By: Ken Ligon III

We have received a number of inquiries regarding State Street Bank statements and a column labeled **Unrealized gains/losses**, especially as it pertains to bonds. For some clients, this column shows a negative number and suggests a loss on the bonds holdings. Rather, this is a reflection of the fact that most bonds we buy today are purchased at a *premium*.

We all know how remarkably low interest rates are today; in fact some of the lowest rates on record. PASI primarily buys bonds for our clients in the secondary market. Most of these bonds were first issued 5-7 years ago when interest rates were much higher, thus the interest payments (or coupons) exceed current rates. When we buy these bonds we pay a *premium*, an amount above what you will receive when the bonds mature. But the additional interest collected while you own the bond compensates you for the fact that you will get less back in principal.

Consider the following example: if we were to buy a brand new one year bond at issue with a principal value of \$100,000 and an interest rate of 3%, we would pay \$100,000 and earn \$3,000 in interest for the year. If instead we bought a \$100,000 bond in the secondary bond market issued several years ago, with a 6% coupon and one year left until maturity, we would have to pay \$103,000 for the bond or a “premium.” The total interest earned on the 6% bond will be \$6,000, but when the bond reaches maturity at year-end we will only get \$100,000 in principal. We receive \$3,000 less than we paid for the bond, but collect \$6,000 interest, so our **total return** is the same as the 1-year bond that we bought at issue, \$3,000.

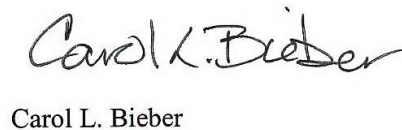
Returning to the bank statement and the column labeled **Unrealized gains/losses**, if the column shows a negative number it likely means we bought premium bonds in your account. But 100% of the unrealized loss shown will be returned to you in the form of higher interest payments. The inner workings of the bond market can be a bit confusing but rest assured you are not losing money on your bonds. We welcome any additional questions you may have on this issue.



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