Lighthouse White Paper

Accessing Global Risks

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LIGHTHOUSE
WEALTH MANAGEMENT

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Preface

"Politics is not the art of the possible. It consists of choosing between the disastrous and the unpalatable."

John Kenneth Galbraith - Economist

For almost forty years the global economy has functioned with a few "certainties" that afforded the investment markets resilience in the face of danger. Imbedded in these "certainties" were assumptions and misplaced faith that more money would fix economic problems.

Today, the global economy is still facing a serious financial crisis whose origins began in the 1970's, were exacerbated in the 80-90's and finally came to a head in 2008. Since 2008, economic "certainties" have begun to be not so certain, assumptions are living up to what people say about assumptions and the risks investors face have increased. Not only have the risks changed but also the likelihood of the materialization of such risks as well as the power of the consequences.

In this white paper we will address the new entrants to the game of risk management in regard to investment portfolios and the maintenance of one's wealth. Hopefully, we can provide clarity of thought and guidance on risk management efforts for investment portfolios.

Defining Risk

Risk is a central term for gamblers and insurance adjusters but also of extreme importance to investors as well. In the financial world there are really two types of risk - pure and what we will call investment risk. Pure risk is a clear cut chance of loss or no loss. A good example of a pure risk is the ownership of property where an event such as a hurricane would result in a loss or no loss. On the other hand, investment risk involves the chance of loss, no loss or gain.

The amount of investment risk one should take has to do with information, conditions and application of hedges. For clarity, a hedge is a procedure by which offsetting transactions are used to attempt to break even.

In today's world the application of hedges are of critical importance as global risks are mounting.

Investor Risks

Investors must contended with a variety of variables that put particular investments at risk. Such as:

- Interest rate risk - This type of risk can impact investments in different ways. An example would be if interest rates rise. Rising rates can negatively impact bond prices as well as hinder businesses or governments that heavily rely on borrowing.

- Currency risk - Again, this risk can impact businesses positively or negatively depending on the direction of currency fluctuations.

- Inflation risk - We will stick to the common understanding of inflation which is rising prices as a result of excess money chasing the same or smaller number of goods.

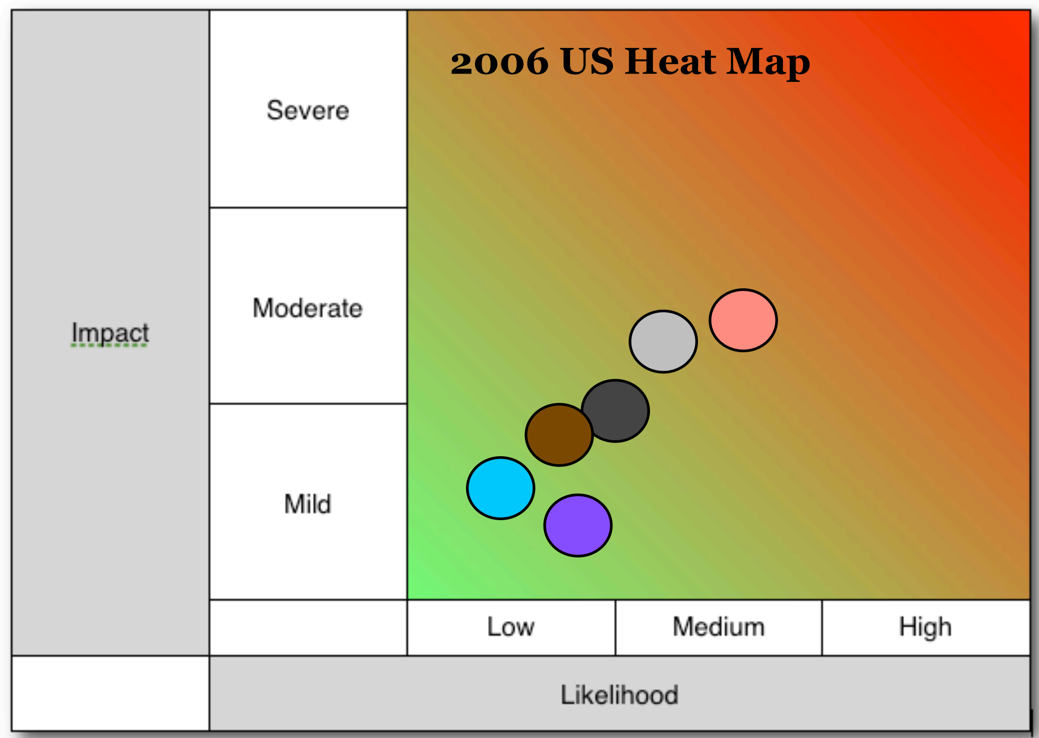
- Political risk - This risk occurs when there is a risk to a business, industry or economy due to political instability, uncertainty or government over-reach.

- Market risk - Market risk impacts investors on a number of levels from fluctuations in values of the overall investing markets to a new level which is the actual viability of the markets. The growing use of computer model trading and high frequency trading has made the markets sensitive and susceptible to disruption. In addition, we are seeing problems in the settlement of transactions as well as significant rules violations by market participants.

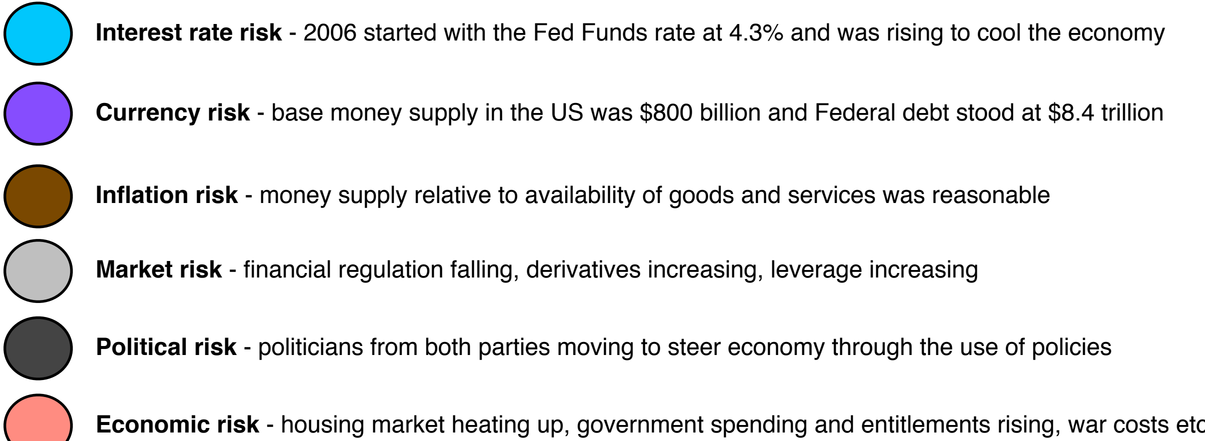
- Economic risk - Investment markets float on the underlying economies and by extension the global economy. Problems or weakness in economies will translate into weakness or problems in many investments dependent on the efficient functioning of economies.

Pre-Crisis US Risk Profile

The purpose of this white paper is not to delve deeply into the current causes of the ills of the economic world. For this reason we will limit history to the early part of this new century. We think it is important to have a frame of reference when looking at risk relative to investing. Therefore, we will look at the likelihood and potential impact of particular risks as they were in 2006.

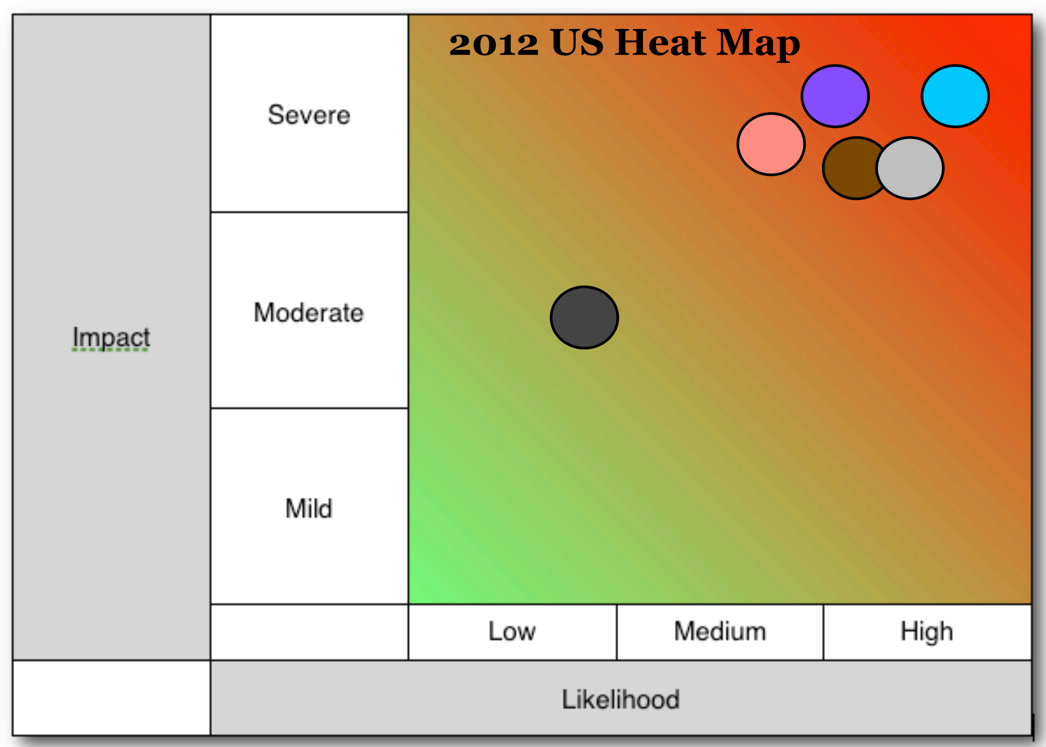


2006 US Risk Heat Map Components

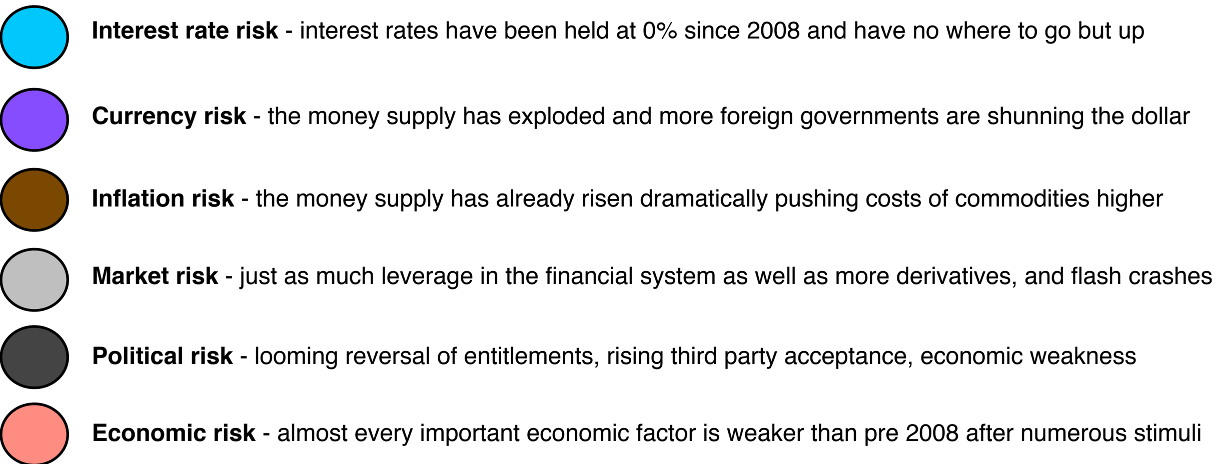


2012 US Risk Profile

In 2008 the global economy ran into a financial crisis. In 2012, global central banks are still fighting deflationary forces by attempting to reflate the global economy. All the while the world is struggling with unsustainable sovereign debts. In the following pages we will present the 2012 risk heat maps for the US, developed international markets and emerging markets along with comments supporting our opinions of the macro risks.



2012 US Risk Heat Map Components



2012 US Risk Profile Comments

Interest rate risk
Interest rates have been at 0% since 2008 and are forecasted to remain there until, at least, 2015. The potential collateral damage from such a policy abounds. Typically, the Federal Reserve (FED) will raise interest rates to cool the economy down. The US economy is no where near heating up so a rise in rates will likely not come from this catalyst. A rise in rates could come from investors losing confidence in the FED's ability to manage the US dollar and therefore demand higher rates. In addition, to keep rates down the US is taking on more debt which means when rates do rise the US will be paying higher interest on elevated debt. Also consider that an unexpected rise in interest rates could very easily derail what economic recovery we have in place. With no where to go but up or stay flat the prospect for interest rate risk is extraordinarily high.

Currency risk
As is true with just about anything one can think of, if you create to much of something its value goes down. The amount of US base money has exploded in the last five years. In the short-term such an explosion has the positive affect of making exports cheaper but long-term it could destroy or impair the currency. Unfortunately, the FED and the government are fighting deflation with money printing and show no signs of stopping. If seen through to a natural conclusion fighting deflation with money printing, on the trajectory we are on, will have grave consequences to our currency. Keep in mind all western governments are doing the same thing.

Inflation risk
It is important to remember that inflation is the expansion of the money supply with the side affect of rising prices as there is more money chasing the same number or fewer goods. Since 2008 the US alone has increased the base money supply from $800 billion to over $2.7 trillion. Typically, commodity price increases appear first in a reflationary (money printing) environment. Accordingly, we have been witness to such price increases. Conversely, as the money supply is exploding we are not seeing the amount of goods and services increasing at the same rate. More money chasing the same or fewer goods produces price increases. Once the velocity of money picks up (velocity being how quickly money moves through the economy) we are likely to see prices increase faster. History shows the central banks have never decreased the money supply, therefore, price inflation is a very real risk.

Market risk
The primary forces that shook the investing markets in 2007-2008 were leverage, derivative investments and excessive risk taking by big Wall Street firms. The amount of leverage in the markets is the same if not higher currently as the zero interest rate policy is forcing Wall Street and many investors to reach for more return through increased risk taking. In the last year we have seen two, sizable futures market makers (MF Global and PFG Best) go bust by not only taking excessive risk but doing it with ill-gotten investor money. Lastly, the notional value of global derivative investments have increased from over $600 trillion in 2008 to over $800 trillion today. Worse yet, since 2008, in the US the derivative exposure is now concentrated in a few Wall Street banks. Therefore, we see the market risks, today, as significantly higher than in 2008.

Political risk
Over the last few decades, political stress has stealthily been building. In the last few years the fissures have begun to open to a point where third political parties have started to make headway. The primary wedge separating the political divide is fiscal management. We believe it is safe to say that as the politicos come to terms with the idea

that spending has to reduce the stress on the political system will increase more.

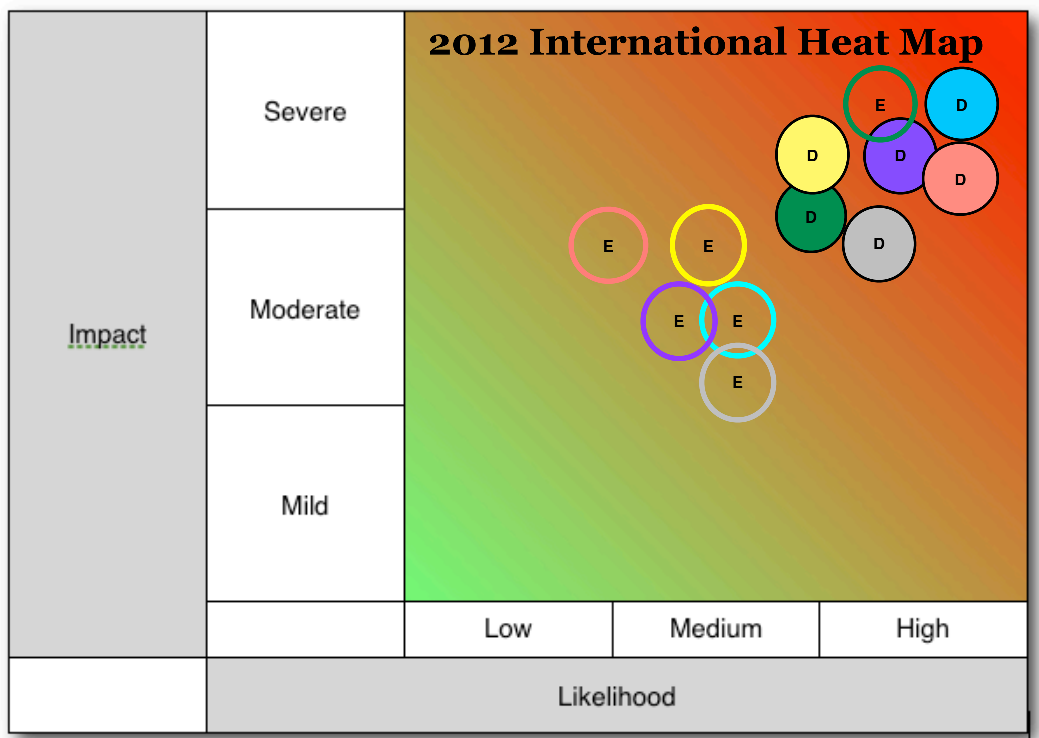
It is obvious to everyone inside and outside government that the current spending/debt path is unsustainable and will require cuts. The problem is, and has been, no one wants to be on the receiving end of the spending cuts. As long as the economy remains weak and the social divide widens the risk to the political system will grow. Lastly, the decades-long, political power grab and crony capitalistic bent in the US is resulting in less freedom and a growing social divide.

Economic risk

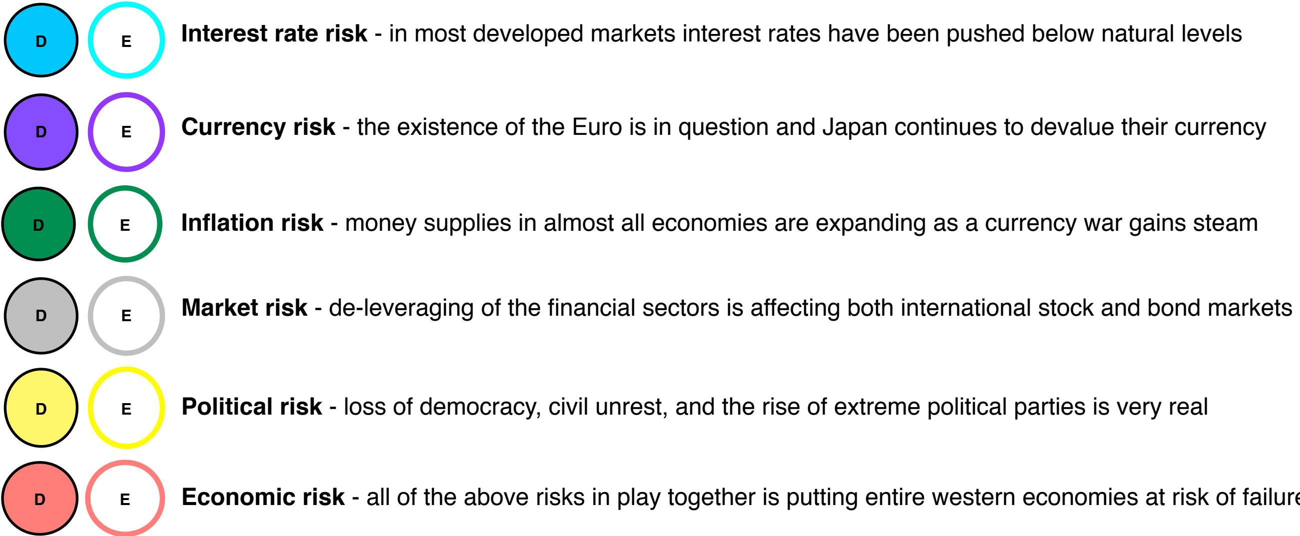
Economic risk cannot be overstated when considering the extent of the economic experiments that global central banks are attempting. There is no real winner in a fight between deflation and inflation. If either side wins the result is economic pain only in different forms. Deficits, entitlements, demographics, currency wars and loss of political will to right the ship are all converging to create a dire economic outlook for not only the US but also many other western economies. For these reasons and more the global economy is in a very fragile state.

2012 International Risk Profile

What started in 2008 as a financial crisis in the US has now become a global financial and debt crisis. Very simply the global super-debt cycle is coming to an end (has come to an end in some parts). The implications of such are being felt socially, politically and economically. Below is our risk assessment of international market via our risk heat mapping. Circles with a "**D**" are developed markets and circles with an "**E**" are emerging markets.



2012 International Risk Heat Map Components



2012 International Risk Profile Comments

Interest rate risk

Developed Markets - The European Monetary Union (EMU), Japan, Hong Kong and the UK are all at unprecedentedly low interest rates. As in the United States, lowering interest rates has been the remedy for economic distress in the past. Conversely, rising rates were used to cool an expanding economy. Over the last two years we have seen interest rates rise drastically in Greece, Spain, Italy, Ireland, and Portugal. It is safe to say that rising interest rates is not a risk but a full blown, dangerous reality for many European nations. With rates so low the risks of rising rates (wether on purpose or accident) is very real.

Emerging Markets - The major emerging market nations still have plenty of room to lower rates if needed. As well, with rates not in the zero range a move up in rates would not be as catastrophic to these economies.

Currency risk

Developed Markets - Currency War III started in earnest in 2010 as every currency in the world began a race to the bottom. Very simply the world's currencies are being held hostage to the US Federal Reserve and the European Central Bank. Global governments face the dilemma of letting their currencies appreciate relative to the US dollar or Euro thereby hurting their exports or creating an inflationary environment at home by inflating their currencies to keep up with the US and Europe. As of the end of 2012 all of the world's major currencies are devaluing their currencies by "printing" more and more paper money. This race to the bottom is very unstable to global currencies.

Emerging Markets - Many emerging markets have resisted expanding their currency supplies allowing their currencies to appreciate which gives their citizens greater purchasing power of foreign goods. Emerging market nations that have export based economies have been forced to join the currency war to make their exports attractive to the world.

Inflation risk

Developed Markets - As indicated above global monetary bases are being expanded at an alarming pace. Such expansions are leading to rising commodity and food prices. Even though the global economy is trying to retrench central banks are doing their best to reflate the economies and cajole consumers to keep spending. As the speed at which the increased money starts moving we are at a large risk of prices rising quickly. On the other hand, even if money does not change hands quickly, prices could start rising from a reduction in goods and services relative to an expanding money supply. As well, if there is a loss in confidence in a currency inflation will take hold as prices are bid up in an attempt to spend away increasingly invaluable money.

Emerging Markets - In emerging economies like China and India, inflation is very much a problem. As these economies expand their money supplies the cost of food has risen substantially. This would be bad for any nation but in emerging economies the percent of income spent on food is in the 30% range versus the sub 10% range in developed nations.

Market risk

Developed Markets - The ongoing de-leveraging of the financial sector in Europe is placing strain on the entire economy of the European continent. Such strains are becoming evident in the bond markets through higher borrowing rates for sovereigns as well as pressure on the stock

exchanges of the heavily indebted, southern, European countries.

Emerging Markets - Over the last few years a number of emerging market economies have actually put capital controls in place to limit money flooding into their markets. It is true that the emerging market nations are very closely linked to the developing markets. But many of the emerging market nations are backed by economies not saddled in debt. As well, the banking and financial systems in many emerging economies are not at risk since they have had little participation in the debt and risky investing problems of western financial systems. Low debt and less leverage in the financial systems means less stress on the investing markets.

Political risk

Developed Markets - Both Europe and Japan have seen heightened political stress. For Japan, their economy is going on 20 years of stagnancy which has taken its toll on the populace. Instead of facing the structural problems, Japanese politicians have propped up insolvent banks and papered over their fiscal problems. The prolonged Japanese economic dislocation has resulted in political turnover. In Europe, the governments of the productive northern European countries are moving away from the wishes of the man on the street by propping up the profligate southern nations. Conversely, the southern European nations are moving away from the wishes of the man on the street as they continue to subject the populace to austerity in exchange for kicking economic storms down the road. In both the northern and southern nations the rift between politicians/technocrats and the people have opened the way for extreme political movements and violence.

Emerging Markets - Within the spectrum of emerging market nations, political risk is one area where there is polarity. Some nations like Brazil, Indonesia, India, South Korea and Turkey have relatively stable governments. Conversely, we are seeing increased political instability in the Middle East countries as well as some Latin American countries. Overall, the emerging market nations appear to be making progress governing versus their developing nations partners.

Economic risk

Developed Markets - As indicated above, economic risk cannot be overstated in the developed nations. With issues ranging from currency wars, currency destruction, massive sovereign debts, demographic challenges, and shaky financial systems it is no wonder the global economy is still very fragile. So long as western governments continue to fight the de-leveraging with reflationary money printing polices the fragility of economies will remain.

Emerging Markets - In the last 15 years many emerging market nations from Russia to Brazil to many Asian nations have gone through serious economic times. Now on the other side of currency and debt problems of their own, many emerging market nations have healthier economies with lower debt levels then their western brethren. Lower debt levels alone gives many emerging market nations an upper hand in the global economy. This is not to mention that many emerging market nations have more favorable demographics. Stable currencies, growing influence in the world, resource rich, and in many cases stability on politics are all working in favor of emerging economies.

CONCLUSION

Why do people put their wealth at risk by investing? The answer for most investors is to have their wealth grow. Unfortunately, investing is not a single risk process. Investment risks are not static. As we have shown in this paper, there are many risks involved in growing wealth. Further, the complexion of risk, as it relates to investors, has changed significantly in just five, short years.

Presently, investors are starting to learn that there is more than just "stock market" risk that can hinder portfolio growth and threaten the safety of their wealth.

It has been decades since investors had to worry about significant inflation risk. Not in anyone's lifetime have we had to worry about unsustainable debt. Not since the 1800's have American's had to worry about the soundness of their currency. So, not only are there many unprecedented risks all at one time but they are also global in nature.

We do not know what catalyst or hazard, if any, will trigger any one of the risks mentioned in this paper. But, we do know that there are ways to try to insulate wealth from the destructive power of inflation, interest rate rises, currency crises and the like. To address risk in a portfolio it requires risk identification, likelihood and possible impact. On the other side of such an exercise an investor can then look to diversify some of this risk out of a portfolio through investment hedges.

It is paramount to keep in mind that the application of hedges or levels of protection will likely slow a portfolio's growth rate. The usefulness of the hedge is seen if the worst case scenario (the reason you hedged) comes to fruition.

For decades investors only really had to fear the gyrations of the stock market as the global economy worked through natural business cycles. To stem stock market risk stock investors could hold a bond portfolio that tended to move opposite of stocks. This worked swimmingly as interest rates slowly wound their way down from 20% in the 1980's to the current 0%. This forty year gentle downward slope in interest rates bolstered the asset class that investors relied on for "diversification." The question is now what? Interest rates will not stay zero forever and when they rise the ying (bonds) to the stock market's yang will be gone. This is just one example of how the risk profile of an investment like bonds can change dramatically.

As you can see, the risks are many, probabilities high and impacts profound. As the number of real risks to wealth are identified and addressed in a portfolio the more likely growth of the portfolio will be impacted. Essentially, investors that hedge risk may have to give up some growth in favor of capital and purchasing power preservation. Why? Very simply, the more hedges in place the less invested for direct growth.

This is not the world we would like to be investing in but it is the current realities. In our opinion, the sooner investors address risk in portfolios the better as crises often leave little time for placing hedges.

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