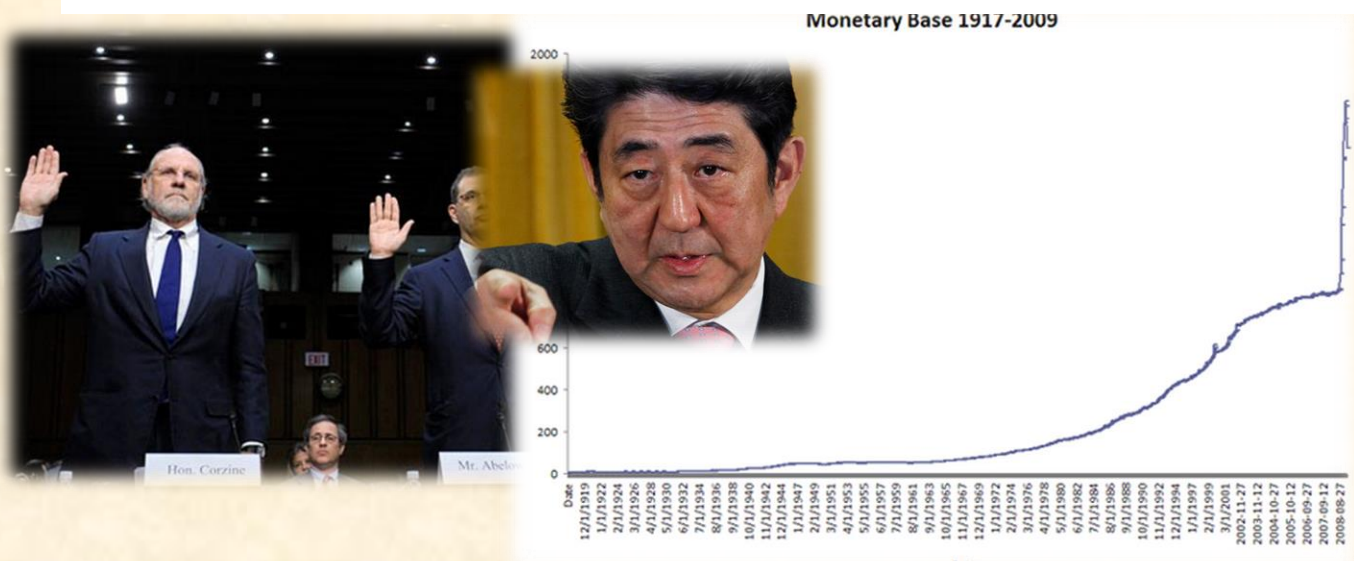
SURVIVING THE CRISIS: AN INVESTORS' GUIDE

Figure 1 Historical Velocity of Money



If the Crisis in Cyprus has taught us anything, it's taught us that no financial assets are safe anymore, even bank deposits. Similar proposals have been suggested in New Zealand, Canada, and the EU. But also its taught us that **for smart money there is no crisis but only opportunity**.

*With every passing day, it becomes clearer and clearer the Cyprus deposit confiscation "news" was the **most unsurprising** outcome for the nation's financial system and was known by virtually everyone on the ground days and weeks in advance: first it was disclosed that Russians had been pulling their money, then it was suggested the president himself had made sure some €21 million of his family's money was parked safely in London, then we showed a massive surge in Cyprus deposit outflows in February, and now the latest news is that a list of 132 companies and individuals has emerged who withdrew their €-denominated deposits in the two weeks from March 1 to March 15, among which the previously noted company Loutsios & Sons which is alleged to have ties with the current Cypriot president Anastasiadis.*

Somehow, many depositors knew of pending trouble and were able to withdraw their funds. Even after accounts were frozen in Cyprus, clients in Moscow and London were able to withdraw their funds.

"These people who got their money out of Cyprus were not all insiders, bankers, or financial analysts. They were all informed. What is information like that worth?" – Anonymous Banker

Cases like this are not new, although this was the most severe. Since 2005 it's happened with Refco, Lehman Brothers, PFG, MF Global, Bear Stearns, and many others, too many to mention. Many disregard these as isolated incidents or simply fraud. But in the case of Cyprus no fraud was involved. These are cases of massive institutional losses, we haven't even considered the global devaluation of currencies.

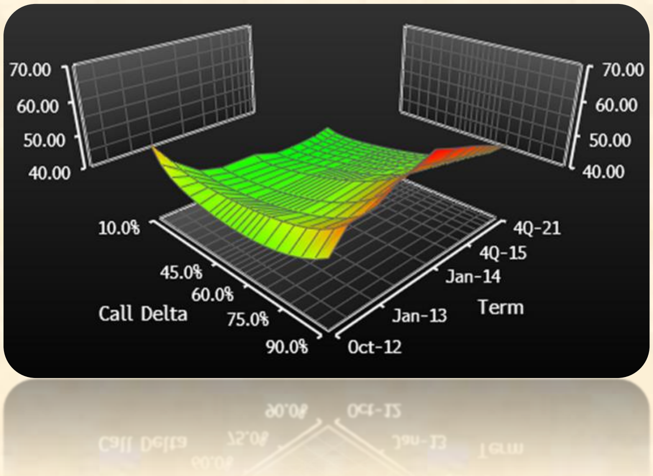
Few places are left to invest, while the US stock market is near all time highs, many analysts such as Paul Craig Roberts are worried about a 'triple threat': a bond bubble, a dollar bubble, and stock market bubble. Other regional bubbles such as European real-estate, exacerbated by the banking crisis, could also pop. *So where is left for investors to keep their funds safe and invest?*

1. The answer is, the first step is to open your own financial institution.

The crisis is not only for the uninformed it's also for retail. Banks which are safe, such as Citi UK may have $50 Million account opening minimums. But a bank can be opened in Malta for only $7 Million; so why would any investor with that much money NOT open his own bank?

While many are getting slaughtered, some of the world's wealthiest and corporate elite have never done better. Watch this video just to get an idea of how well they've done. Making good investments is important, but just by having your own institution one would have saved himself from the 60% haircut some depositors received in Cyprus. So making good investments is irrelevant if your deposits are wiped out. If you think this concept by itself is unique, think again. Hundreds of private family owned institutions exist in the world in different forms; family offices, private banks, and family foundations.

2. Use derivatives to protect yourself, not to profit.



Derivatives such as options, credit derivatives, and others can be used like an insurance against portfolio risk. When Bear Stearns collapsed, other investment banks had losses but they made more money on their derivatives contracts than they lost in the collapse. It's literally possible to insure yourself against your own losses. Used as a means of risky bets to gain profits derivatives can be very risky. But when used like insurance they can protect your business and portfolio from adverse market changes.

3. Continue doing what you are doing (but with protection).

This is not a suggestion to quit your business activities or invest in something different. It's possible to continue what you are doing but through your own institution. For example if you have a brokerage account, it's possible to simply transfer that account to your own institution and continue doing as you were. The only difference would be the custody (and you might not charge yourself such high fees). But this key difference is the difference between being wiped out by an insolvency or not. Once your funds are safe at your institution you can implement hedging instruments which will act like insurance on your existing business. For example if you are in the oil business, it might be a good idea to go long Uranium companies (Nuclear energy being a hedge against a downturn in oil). If you have a lot of real estate you might want to short the REIT closest to your region. This can be done using a small percentage of overall capital using options.

4. Don't be complacent and deny global financial realities.

If someone said in 2007 that Lehman Brothers would collapse they likely wouldn't believe you, but yet it did. Investors become complacent and are reinforced by mainstream media suggesting the crisis is over. Certainly equity managers and corporate executives have every reason to convince others the world is as it should be. But information, hard facts, do not indicate this. For example, we would be led to believe that the Crisis in Cyprus is over for now. But UBS has pointed out that it's really an indication of monetary union collapse:

There are four traits that UBS identified as common trends around the breakup of a monetary union. So has Cyprus (as is tirelessly pointed out, only 0.2% of the Euro area measured by GDP) set a course for the Euro's destruction? Indeed, with Cyprus having checked the first three items on that list, while it has not left the Euro (yet), UBS concludes, ***"it may well be occupying a seat very close to the exit."***

5. The new diversification isn't to sit in bonds, stocks, commodities, and real estate and wait to lose, it's to actively manage your portfolio.

The traditional thinking of splitting up your portfolio into segments with the idea that it will all balance out in the end (stocks up, bonds down, overall you win) just doesn't work anymore. For example we've seen this past year a rally in both bonds and stocks because of the Fed's QE programs. A sell off in the stock market could parallel a sell off in the bond market, which would be a lose lose. Another problem with this traditional portfolio management is that there are new financial realities that make diversification no longer viable. In a healthy economy, one can simply bet on all horses and the winning horse will make up for all the losses. But today all the horses are sick, and sometimes races are cancelled. One example is while the GDP remains constant, the velocity of money is worse than depression levels.

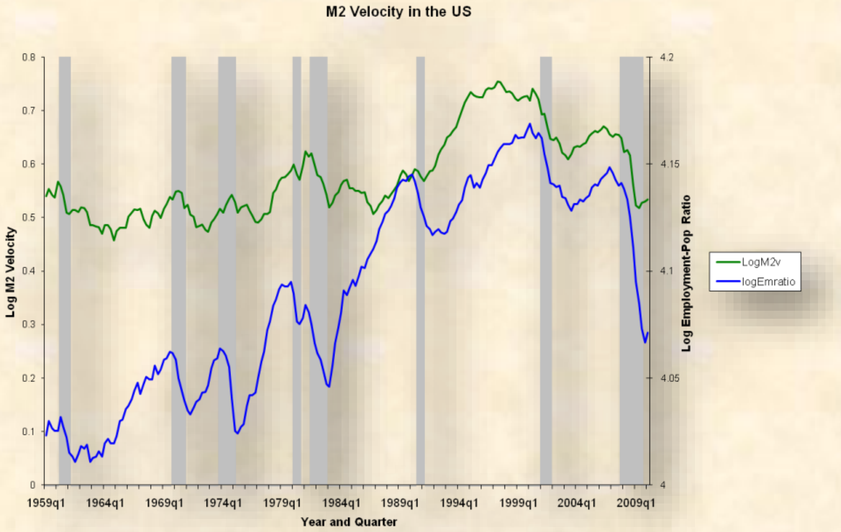


Figure 2 - Velocity of Money in US 1960 - 2009

The velocity of money (also called velocity of circulation and, much earlier, currency) is the average frequency with which a unit of money is spent on new goods and services produced domestically in a specific period of time.

The velocity of money is an important number because if a $15 Trillion GDP economy turn itself over 10 times in a year vs. 5 times, it's the economic equivalent of having $30 Trillion (you get $15 twice). In this economic climate it's hard for traditional businesses to make money the way they used to, which is one reason why corporations are sitting on record levels of cash. What's strange is this has been coincided with an unprecedented money creation by the Fed (and other central banks). So where's the money?

6. Don't operate in a single jurisdiction

There isn't any regulatory panacea. Every region has its share of problems. But if you're only operating in one jurisdiction, you may be the victim of capital controls, or worse. Operating in at least a minimum of 2 jurisdictions is a must, with 3 being ideal (you can't sit on a 2 legged chair). That doesn't mean you have to live in these places but at least to have a presence there, an entity that suits your situation, and ideally some outlet *'just in case'.*

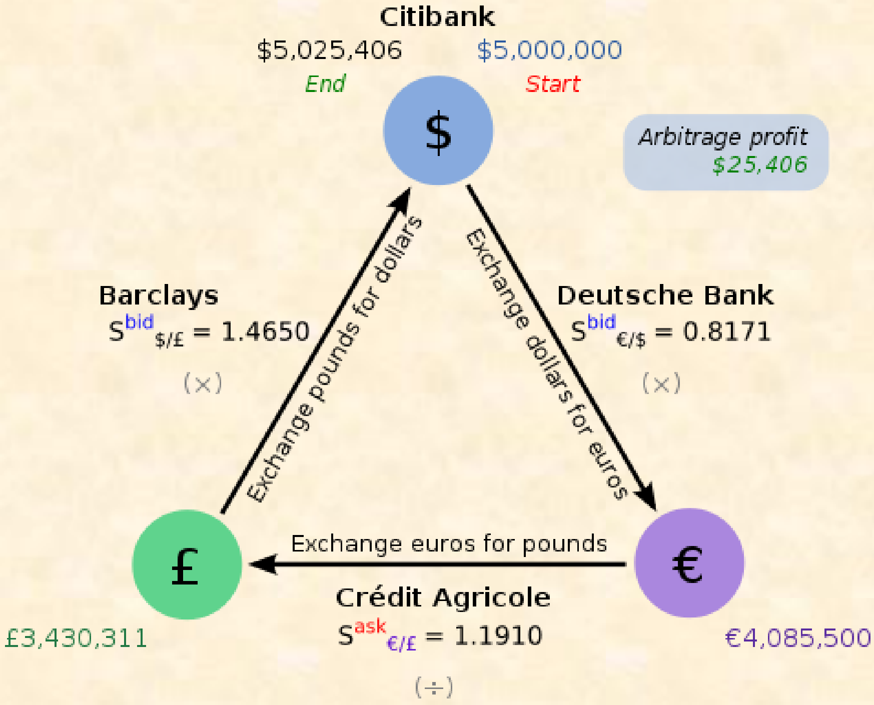


Figure 3 - When you are in 3 locations you can profit by doing nothing

7. Adapt

Investors should be judged on their ability to adapt to different epochs, not cycles. An epoch may be 40-50 years in time, perhaps longer. Warren is the Oracle, but if an epoch changes will he and others like him be around to adapt to it? -Bill Gross, Managing Director of the world's largest Bond fund

Investors create wealth and protect wealth by being in long term trends such as the stock market boom of the 1990's, the commodity boom of the 2000's (most notably led by Gold) and other trends. The financial crisis is not the end of the world, it's the end of an investing epoch.

What is certain about the future, the new epoch, is that it will be different than the past. What will be the new types of investments that will define the new paradigm? That is not going to be a 1 sentence answer. But the approach is clear; by having your own bank and operating in multiple jurisdictions, by utilizing hedging instruments to protect yourself, gives investors the proper armor to protect themselves in the new paradigm investing war. Trillions will be lost but also made, in fact what defined the US post WW2 boom was economic devastation of much of the rest of the world. Through the process of protecting yourself, new opportunities can be carefully explored, by using protective tools which are available.

8. Don't be unrealistic

If an economy grows by 3%, why should investors expect more than 3% return? Where does the extra return come from, if not extracted from the real economy? That doesn't mean above average returns can't be achieved, just that they shouldn't be expected. In a crisis the mantra is 'prepare for the worst, hope for the best.' By eliminating risks, and containing losses, whatever is left is a profit. That profit can be substantial as opportunities emerge in the crisis. But they shouldn't be expected, nor should opportunities be chased. Be prepared to miss a few because of bad luck or not having available resources, others will come.

9. Be prepared to explore uncharted territories

The best 'trade' of the week would have been an investment in BitCoin, the new internet currency. Backed by only high grade encryption, <u>the currency has 'gone parabolic' in the last week</u>, being up 50% in the week but up over 14x or 1400% for the year. It's laughable by the mainstream investing community, yet anyone who bought the currency 1 year ago would have a 1400% return. This isn't an excuse to go investing in penny stocks, simply to keep an open mind about new ways to invest. BitCoin received the recent surge due to the Crisis in Cyprus, because investors don't feel comfortable keeping their money in banks or even in Euros. But the US Dollar is not much better. In fact, no major currency seems to be able to avoid the inevitable participation in the currency wars. This was the thinking of those who invested in BitCoin, driving up the price.

10. Be liquid, be ready

Having assets such as real estate can be tricky in a downturn or real estate collapse. Long term bonds are great if you are willing to wait until maturity to avoid a haircut. Hedge Funds with lock out periods can be risky, as the famous Paulson fund recently lost 46%. Also such locked up illiquid investments are the subject of potential insolvency risks such as we saw with Lehman Brothers and Cyprus banks.

11. Think Globally, Act Locally

This powerful phrase is extremely important to understand and implement in the current situation. With markets being electronic and with the internet, the worldwide financial system is as global as it ever was. No region is completely isolated from the financial contagion spreading. But also opportunities are accessible to nearly anyone. But we all live and work in our local community. By understanding the global perspective, and implementing it locally, we can maximize our potential.

Many people do the opposite, a very dangerous proposition. They think locally and act globally. The local rules in your environment don't necessarily apply to the whole world. The way your village or town operates isn't the only way any village works. Not to mention some live in cities or in other cultures. In the case of Forex, Americans are guilty of this. They say things like "But I buy everything in Dollars" and some aren't aware that other countries even have other currencies. This may seem like mere ignorance, but others are also guilty of the same. European banks bought toxic debt sold by US firms assuming that the culture and regulation was similar to what they had in Europe. European banks simply didn't have a concept of combining subprime debt with AAA securities creating a marketable CDO. This bankrupt townships in Norway, many banks, and was a contributing factor to the current European financial crisis.

12. Create a defense line

With available resources every investor should have the ability to retreat to a debt-free situation where one can live without worry. This means different things for different people, it may mean buying a reasonably priced property for cash in the event of disaster, or it may mean unwinding some of your business operations. Be prepared to retreat to your defense line as a worst case scenario. Most do not have this and it creates a stress that ultimately will lead to bad decisions. And you might need it!

13. Beef up your computer skills

The majority of the world economy now runs on computer systems. This can help with your business but most importantly with your investments. An understanding of information theory and information security can help evaluate investments for yourself rather than trusting an expert that may not know himself. The majority of volume of US stocks is algorithmic, and a growing number of investments are based on systematic trading vs. humans. Also, algorithmic trading can have limited and controlled risks, whereas many of the trading losses we've seen have been because of humans (UBS, Societe General, Barings Bank). An understanding of computers will greatly help an understanding of the markets, not only because the markets are run by computers but because a computer is a system like the markets are a system. Markets are structured and follow a set of rules (called an algorithm) much like a computer system. In a system based on rules, understanding algorithms and basic math will help evaluate investment strategies. For example, analyst Harry Markopolos proved that Madoff was a fraud mathematically without any actual inside information that Madoff was in fact a fraud. Other investors came to the same conclusion more anecdotally (Markopolos did an in depth professional analysis).

14. Learn lessons from the past

There are many lessons to be learned from the Cyprus bailout, and plenty of implications for how things may develop in the future. We list 25 here, but there are more.

Lesson 1: Do not underestimate the ability of the Eurozone to do the right thing – after all the alternatives are exhausted;

Lesson 2: Eleventh hour deals can often lead to mistakes and have unintended consequences. The decision to haircut depositors under EUR 100k was a pothole the Troika fell into. It questioned the integrity of the EUR 100k deposit guarantee;

Lesson 3: The disappearance of Mario Monti from the scene has reduced the influence the South has on decisions about the future of the euro;

Lesson 4: There appears to be bailout fatigue in Germany, the Netherlands and Finland. Mrs Merkel is prepared to be tougher ahead of the election than many thought;

Lesson 5: The new Chair of the Eurogroup, Mr Dijsselbloem, seems to be a hardliner compared with his predecessor, Mr Junker from Luxembourg;

Lesson 6: Mr Dijsselbloem can sometimes be too outspoken and not sufficiently diplomatic. Beware future gaffes;

Lesson 7: The ECB is prepared to use the ultimate weapon – “no more money for your banks”. This is not exactly ejecting a country from the Eurozone, but would amount to making it very difficult for it to stay in;

Lesson 8: Such a threat has profound political implications and is above even Draghi’s pay grade, so must have the backing of Mrs Merkel and others;

Lesson 9: When a problem is not seen to be systemic, there will be reluctance in Germany and like-minded countries to use taxpayers’ money to solve it. Cost/benefit balancing will ensure each case really is “unique”;

Lesson 10: This puts private interests at greater risk in absorbing the financial pain, or at least the first tranche of it, especially in small non-systemic countries;

Lesson 11: “They” (the Troika) will seek to use private money where they can to limit the size of public sector involvement. While each case is unique, the principles are the same. In Greece, government bondholders took the pain; in Cyprus large depositors. Each case is “unique” but there may well be further “unique cases”, each different in its own special way;

Lesson 12: When it comes to resolving banks’ difficulties there is a hierarchy of who will take the pain: shareholders first, then junior bondholders, then senior bondholders, then large depositors, then the state, then foreign taxpayers;

Lesson 13: How much pain the private sector will take depends on whether or not a problem is seen as “systemic” or not. The less systemic it is, the more private interests will suffer;

Lesson 14: Some countries see firewalls as adequate. So they are now prepared to “burn” stakeholders who were previously protected;

Lesson 15: The probability of direct bank recapitalization by the European Stability Mechanism (ESM) has gone down;

Lesson 16: Moral hazard has been reduced;

Lesson 17: We crossed a Rubicon of sorts when capital controls were introduced in Cyprus. A Cypriot bank euro is not freely exchangeable with German bank euro. The euro area became more fragmented;

Lesson 18: It may be more difficult to remove capital controls than expected;

Lesson 19: A precedent for the use of capital controls has been set that can speed up capital flight in a crisis, raising the probability of their subsequent re-use;

Lesson 20: It would be surprising if larger depositors were not making defensive moves out of weak banks and banking systems. Watch the scale of ECB MROs and ELA operations;

Lesson 21: The Cypriot economy will see a major recession;

Lesson 22: The Cypriot program will, consequently, prove to be too optimistic, there will have to be another;

Lesson 23: While Draghi has bought time, the fundamental problems in the eurozone are a long way from being solved, and can come back to haunt markets;

Lesson 24: Do not expect Russia to take the loss with a feeble protest – there will be consequences;

Lesson 25: Conditionality is very important to the core countries. There is no such thing as a conditions-free bailout. There are no blank cheques and no free access to Outright Monetary Transactions (OMT) or ESM. There is no such thing as a free lunch (unless not having a free lunch threatens the system).

In the last 10 years, if you had just bought Gold and went sailing, you'd have a 600% return.