



DOUCET ASSET MANAGEMENT, LLC

*Quarterly Newsletter*

*Q1 2009*

DOUCET VALUE MOMENTUM PORTFOLIO

DOUCET VALUE INCOME PORTFOLIO

DOUCET MANAGED PORTFOLIO

BIENVILLE MODEL

**January 2009**

### **Is This Time Different?**

*The budget should be balanced, the Treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled, and assistance to foreign lands should be curtailed lest Rome become bankrupt. People must again learn to work, instead of living on public assistance."*

*Cicero 55 BC*

Not much has changed since the days of Cicero. This truth grows increasingly apparent the more I read. Last week, I perused a *Time Magazine* article where the Ford Motor Co. warned Washington of the need for "quick action lest the country spiral into massive unemployment," the Fed Chairman cautioned there would be a "permanent decline of our nation's economic and political power unless the Administration took vigorous action to curb the flow of wealth into oil-country treasuries," the President presented a 31-point economic policy action plan to Congress, and Consumer Confidence was at its lowest level since the survey began in 1946. While these points ring a familiar tone, the article was dated December 9, 1974, three days after the bottom of the '73-74 stock market meltdown. The fact is, while particulars of an economic cycle may change, the cycles themselves are never actually different: not in 55 BC under Cicero, not in 1974 under Gerald Ford and, our thesis is, not in 2009 under Barack Obama. The acute brevity of the financial memory ensures there will always be market booms and busts; when consumer spending halts, the Fed and the Administration will act in eerily reminiscent ways to stimulate the economy; the "velocity of money" will continually ebb and flow because humans are ultimately involved; and pecuniary bubbles and economic opportunities will abound in places never thought possible.

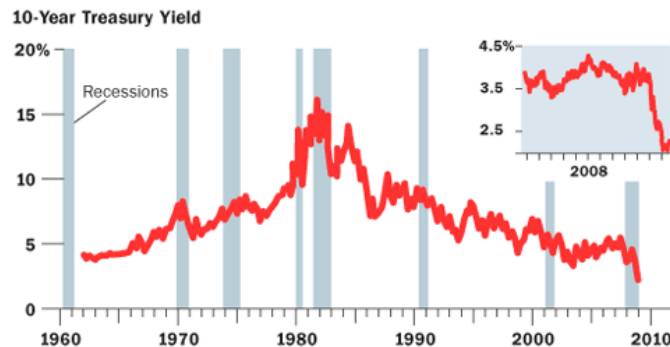
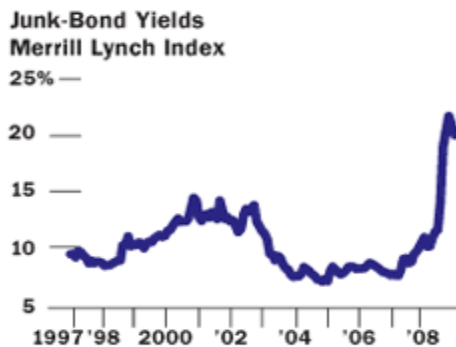
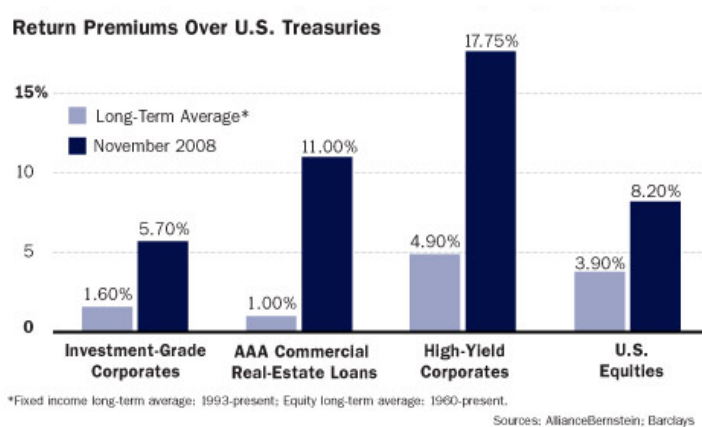
### **Old Bubbles Burst, New Bubbles Form**

It is difficult to know which came first, the chicken or the egg, economic booms or busts. It is the tendency of human nature to go to extremes. In any economic cycle, over-confidence is followed by a lack of confidence, credulity is followed by cynicism, and unreasonably high prices by ridiculously low ones. Governments of all types, past and present, help foster meteoric fluctuations in their respective economies. This whipsawing of markets, in turn, causes economic bubbles to burst, but also has the unintended consequence of helping new bubbles to form in their places. Some of our past newsletters have attempted to highlight a few of the more obvious bubbles: in July, 2007, we stated the spread between "junk" bonds and Treasuries was too narrow and spreads would widen; in July, 2008, we said that \$140 oil would go back to "\$80 before year end;" now we are suggesting new bubbles are present.

### Treasury Bubble?

We believe a bubble has now formed in Treasury securities across all maturities, causing spreads between Treasuries and other fixed income investments to widen well beyond historic levels. In only 18 months, risk premiums investors were willing to pay for asset classes such as investment grade corporate, junk and municipal bonds went from some of the lowest levels in history to some of the highest levels ever seen. U.S. Treasury securities have long been considered the

safest investment in the world. Drove of worried investors have sought this perceived safety in times of financial turmoil. The yield on the 10-year Treasury has now plunged to its lowest levels since the 1940s, while short Treasuries actually traded at a negative yield briefly during the quarter still hover at historic lows.



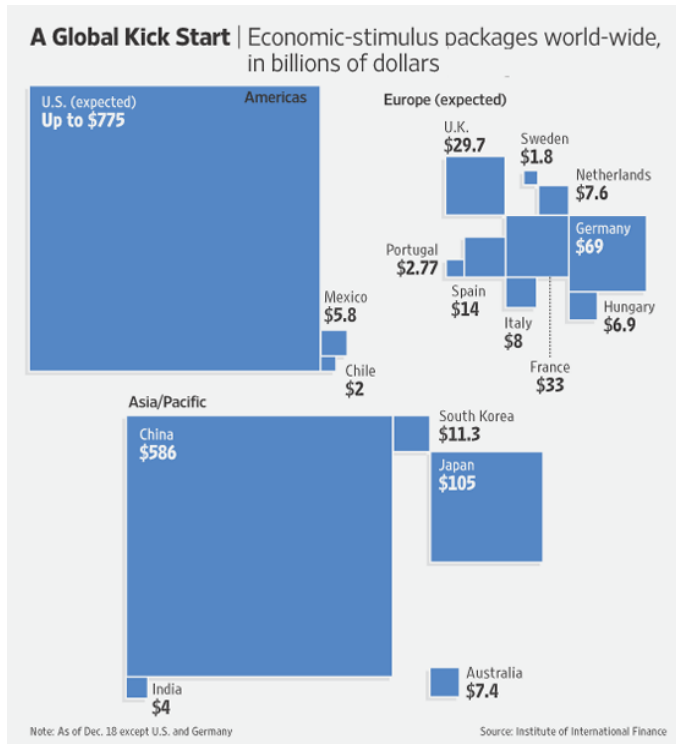
Barron's Financial

However, the “capital protection” Treasuries provide evaporates if any myriad of events occur: the economy begins to show signs of life, money shifts to corporate and other fixed income securities, inflation returns, or the dollar weakens. If the 30-year Treasury were to move from a 3% to 5% yield to maturity, the principal value of that bond would decline 30%. This low return on Treasuries can only persist if a high dose of pessimism continues to infect the investor psyche, prolonging the deep freeze across all financial markets.

The good news for those who are long Treasury securities is, to this point, the government has had little success in stabilizing the banking system, investors believe balance sheets of banks like they believe in the Tooth Fairy, and “mark-to-market” is an arcane accounting system which promises to cure the bubonic plague of toxic assets like the fire cured the rat problem in 14<sup>th</sup> Century England.

### Government Stimulus: Past, Present and Future

So what do the Fed and the Obama Administration do to help thaw these frozen financial markets? The short answer will be everything *including* the “kitchen sink.” To this point, we have been witnesses to the moral hazard of government intervention. The market has been flooded with liquidity, to include cash injected directly into almost any financial institution who stepped to the Fed window. Financial history is replete with examples of these strategies actually working to stabilize the financial markets, but this time around the government has forgotten a few key elements like upside for the taxpayer or accountability on the part of those who control the purse strings.



The next steps are expected to be taken straight from the pages of Great Depression history: the Fed is likely to buy illiquid assets from financial institutions and the Administration will embark on a “New Deal” era stimulus package. The dollar amount of government stimulus is expected to easily cause this period in history to be looked back upon as the “New, New Deal.” And according to the Institute of International Finance, the U.S. is not alone in adopting this approach, as most developed and large emerging nations are planning large stimulus packages as well.

### Velocity of Money

The desired result of the government’s stimulus is to increase the “velocity of money,” or simply put, the frequency money is exchanged in a given period of time. Almost every time money changes hands in America, taxes are created. So it is very much in the interest of the government to

have the economy work.

When money turns over an unsustainable number of times to the point the economy is “overheating,” economists call this inflationary. But, if money transacts too slowly, then demand for goods and services declines, leading possibly to a deflationary scenario. Deflation can be more problematic for an economy because not only do tax revenues dissipate, but risk capital evaporates and jobs are lost. Most investors and economists understand there must be at least a modicum of inflation for capitalism to work.

### Cash

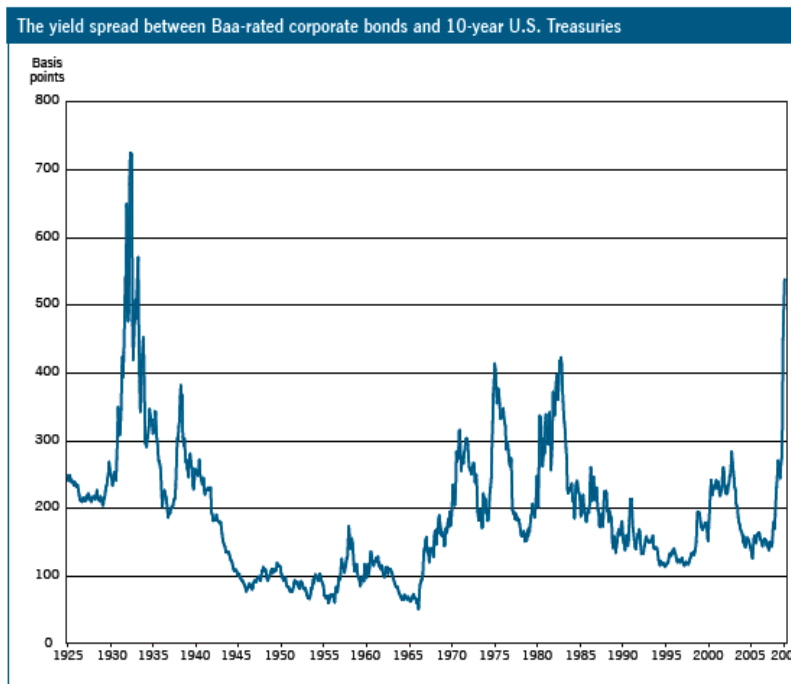
In the short term, the slowing in the velocity of money has already wreaked havoc on the economy, evidenced through shockingly bad news in lagging indicators such as unemployment rates and corporate earnings. The slowdown is further confirmed by the growth of cash in money market funds from record levels of \$3.4 trillion in June 2008 to \$3.9 trillion in January 2009. According to the Investment Company Institute, the amount of money stashed in money-market mutual funds surpassed that in stock mutual funds as of November 2008. The total amount now held by investors in cash, bank deposits, and money market funds is \$8.85 trillion, representing 74% of the market value of U.S. companies, the highest ratio since 1990 according to Federal Reserve Data. This is a mountain of cash earning approximately zero interest.

### Moving Out On The Risk Curve

To paraphrase Occam’s razor, “All other things being equal, the simplest solution is the best.” With developed countries like Iceland and Belgium imploding, stalwarts of American capitalism plummeting to their deaths out of seemingly nowhere, and TARP money disappearing into unknown black holes, it is easy to understand why cash levels are growing and risk capital has abated. A typical economic cycle suggests investors will dip their financial toes back into the water before they plunge back into the markets head first. The Fed’s actions and statements indicate not only further purchases of Fannie Mae and Freddie Mac debt and corporate short-term debt (commercial paper), but steps to bring down longer-term borrowing costs, especially for mortgages. A narrowing in spreads between Treasuries and other fixed income investments

will help some risk capital return to the markets. Other risk capital will return in traditional higher return investments when the volatility in the markets begins to subside. While it is improbable to time a change in market direction, we do expect capital flow to follow a reasonably predictable pattern as credit markets loosen and risk aversion subsides. Re-emergence of some risk capital was seen returning to the debt markets recently, as \$40 billion in new investment grade corporate bonds were issued during the week of January 5<sup>th</sup>, the most since May 2008 according to *Businessweek* (Jan. 26).

### Corporate and Municipal Bond Markets

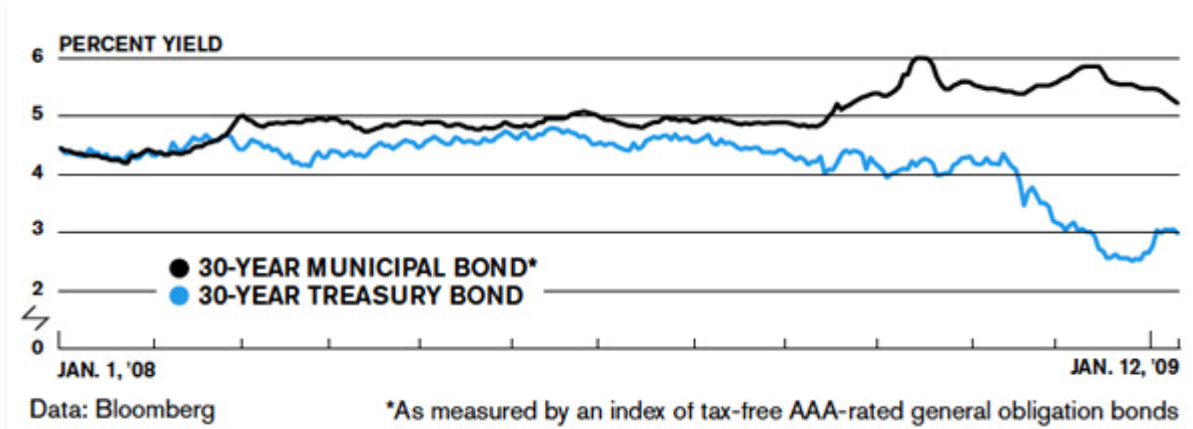


Sources: Global Insight, Moody's Investors Services  
 Unlike fund shares, investments in U.S. Treasuries are guaranteed by the U.S. government.

Capital will first flow from cash to high grade fixed-income investments. In December, investment grade corporate bonds on average yielded 570 basis points higher than comparable treasuries vs. a long-term average yield premium of 160 basis (since 1993 according to data from AllianceBernstein and Barclays). The spread between investment-grade corporates and comparable Treasuries has rarely been greater than 400 basis points.

Perhaps the fixed income area where this anomaly has been most poignantly illustrated is in the municipal market which we detailed in our December special report. "While returns on municipal bonds have historically been about two thirds of

those of U. S. government securities, they are paying higher rates than Treasuries in the current credit crisis..." (Businessweek, October 9, 2008). We believe this abnormality exists because of the temporary loss



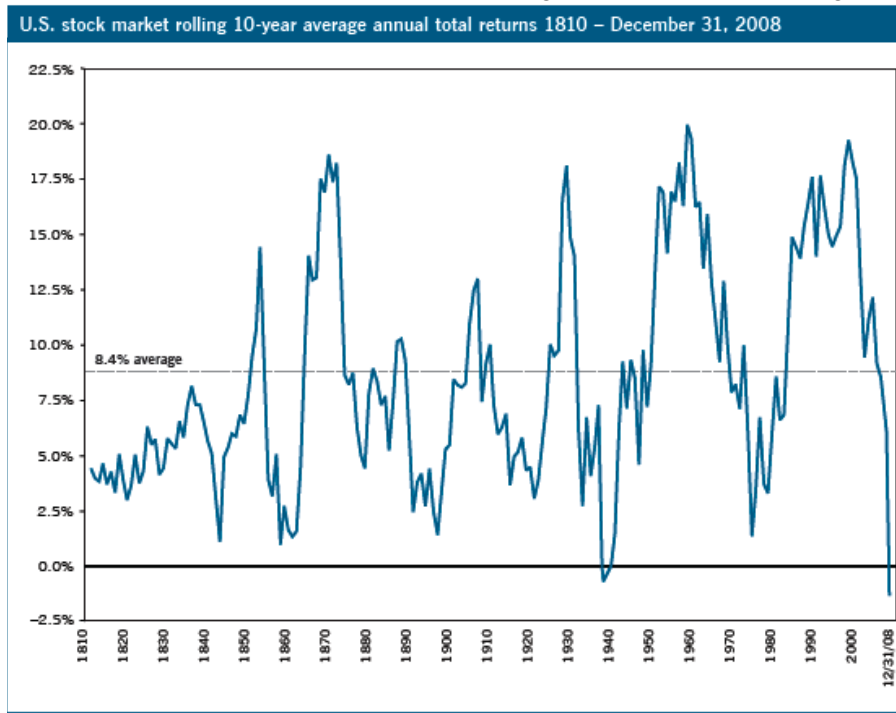
Data: Bloomberg

\*As measured by an index of tax-free AAA-rated general obligation bonds

of the traditional buyers of municipals, over valuation of Treasuries and the deterioration of some municipal credits. (For further information, please contact us for our special report on this topic from December 2008.)

### Dividend-Producing Equities

With the extreme levels of volatility and institutional and individual investors fleeing equities, much value is strewn about the wreckage. The 4th quarter of 2008 was the first time since 1958 that the dividend yield on the S&P 500 exceeded that of the 10-year Treasury bond. Also, the 10 year period ending December 31, 2008 set a record low average annual return for large capitalization stocks of (1.5%) for periods dating back to 1810....that's the year 1810. Previously, the lowest 10-year return was (1.3%) for the period ending in 1938. As credit markets begin to normalize, the first equities expected to benefit will be dividend producing stocks from high quality companies. Companies with healthy balance sheets, strong cash flows, solid competitive positions, and disciplined management teams should emerge from this downturn with more market share and leaner operating structures.



Source: Global Financial Data

### Smaller Equities

Historically, small capitalization stocks suffer the most damage in an economic slowdown, and last year was no exception (see chart below). Lack of liquidity has weighed heavily on returns since the beginning of the flight to quality. However, although small cap equities will be last to benefit in the sequence, they typically outperform in a resurging economy. With the considerable amount of cash on the sidelines, small cap stocks are poised to benefit the most from an increase in capital seeking higher returns.

Source: Bloomberg

		Num. Secs	Average (%)	Median (%)	Std Dev	High	Low	
11)	All Mkt Caps	31)	6270	-27.54	-50.00	45.51	471.43	-100.00
12)	500m-2B	32)	856	-27.63	-28.56	29.38	57.35	-91.19
13)	10B+	33)	193	-27.10	-29.78	17.79	11.18	-76.28
14)	2-10B	34)	469	-32.15	-31.14	22.91	33.57	-92.22
15)	250m-500m	35)	559	-31.22	-35.89	33.88	66.02	-96.18
16)	100m-250m	36)	681	-38.33	-43.46	28.40	47.59	-95.14
17)	< 100m	37)	3502	-46.78	-65.85	56.13	860.00	-100.00

Companies with small market caps (less than \$100 million) lost an average of nearly 47% vs. 27% for the largest companies by market cap (\$10 billion or more).

**Final Thought**

It has rarely, if ever, been correct to assume “this time is different.” Economic booms and busts have occurred throughout history, and while times and circumstances change, the cycle does not. For decades, the U.S. economy benefited from positive underlying trends and investors were rewarded handsomely for bearing risk in the markets. This led to rising bullishness, willingness and expansiveness. These trends reached excesses, and we have seen them correct with a vengeance. Now, we see bubbles and over corrections forming at the other extreme, and likewise, \$9 trillion earning zero interest is not likely to persist. When risk aversion does subside, investors will move out on the risk curve – from cash to corporate and municipal debt to large cap dividend-producing equities to small cap equities – in search of improving returns.

While significant headwinds exist, short-term economic cycles of boom and bust will repeat. Low energy costs, low interest rates, declining new housing starts and other construction, increased money supply....at some point, the cycle turns again. As the passage of time erases all memory of past corrections, investor behavior will likely take asset prices again to unsustainable highs. It will not be different next time either.

If you have any questions regarding your account, the securities or the portfolio in general, please do not hesitate to call Rebecca, David, Roland or myself.

Sincerely,



Chris L. Doucet  
Chief Executive Officer

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- Form ADV: Please contact our office at (205) 414-9788 if you would like to receive a current copy of our Form ADV II or the Schedule H Brochure.
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