



DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter Q2 2010

DOUCET VALUE MOMENTUM PORTFOLIO
DOUCET VALUE INCOME PORTFOLIO
DOUCET MANAGED PORTFOLIO
BIENVILLE MODEL

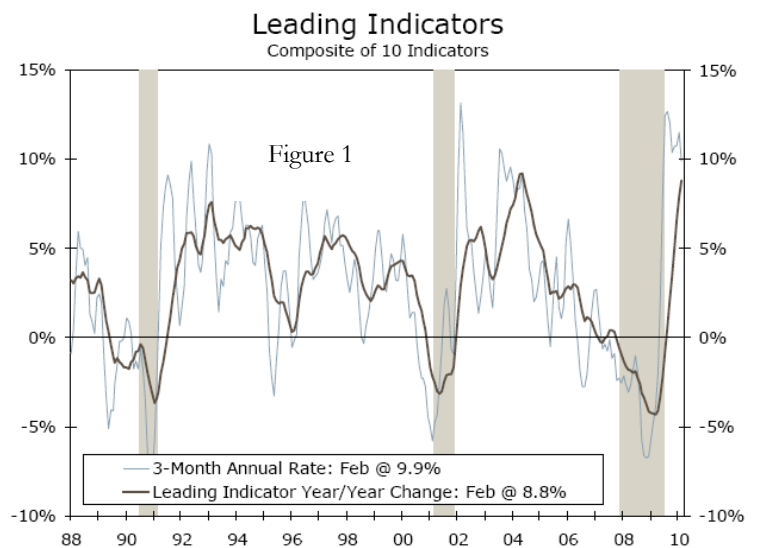
April 2010

Objective Observations

Street signs to the future of the market are rarely visible from the rear-view mirror. Economic expectations are better interpreted by observing “quiet data” rather than focusing on the barking and bantering on the business news networks. If the objective observer were to turn down the volume on the television, he would witness something that resembles an old-fashioned economic recovery instead of this “new normal” which has been receiving so much attention. Yet, at the same time, he could not help but take note of the questionable government spending, ever-mounting debt obligations and weakening U.S. Dollar – all of which may eventually land America in a similar predicament as that of the Emperor in the midst of the parade in Han Christian Andersen’s tale “The Emperor’s New Clothes.” There are several road markers which may show greener pastures ahead in the financial landscape, but much depends on fiscal restraint and responsibility on the part of Washington.

Quiet Data

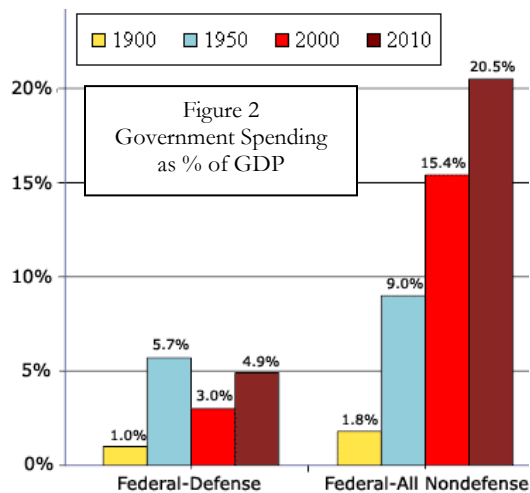
It is human nature to interpret the future by putting the most significance on the recent past. Sensational stories such as Greek debt woes and Goldman Sachs betting against its own products paint a bleak picture of the state of the world and helps Jim Cramer sell ad space for his show on CNBC. Yet, from a purely objective point-of-view, an observer can see plenty of evidence that an economic recovery may be quietly underway. Improving leading economic indicators, as well as data ranging from industrial production to order backlogs to retail sales, indicate the economy is on the mend (Figure 1).



What Comes After a Trillion?

Despite progress, the objective observer understands the United States will experience the “Grand Canyon” of potholes on its road to recovery in the forms of unsustainable deficit spending and total debt obligations. Winding down government spending associated with the recovery could prove much more difficult than it was to convince the American taxpayer these expenses were a good idea in the first place. The Congressional Business Office’s (CBO) Monthly Budget Review shows, for the first six months of Fiscal 2010 (fiscal year ends September 30th), the

government has spent \$1.67 trillion but only collected \$0.953 trillion in taxes and other revenues. In other words, the Federal Government spent 175% of what it made! (The answer to the question, by the way, is quadrillion.)



Debt as a percentage of GDP is now at the highest level the U.S. has ever experienced other than at the conclusion of WWII. And according to the Cato Institute (Figure 2), Federal Government spending, as a percentage of GDP, has increased from 14.7% in 1950 to 25.4% in 2010. But what is more troubling is the ramp in spending in the last decade – from 18.4% of GDP in 2000 to 25.4% in 2010, a 38% increase. Even compared to the WWII period, peak spending did

How did the United States pare down its debt levels after WWII?

The short answer is it did not. In fact, 10 years later (1955), the total debt level was \$274.4 billion or 6.1% higher. But the economy grew faster than the deficit did, with GDP growing from \$221.4 billion in 1945 to \$394.6 billion in 1955, or 78.2%. Also, due to higher taxes and less government – there was no Department of Education, Energy or the EPA in 1945 – the government was able to run primary surpluses. Altogether, the ratio of debt to GDP fell by 83% over the next three decades, bottoming in 1974. About 23% of the reduction can be attributed to inflation.

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not exceed \$1.1 trillion in today’s dollars, and with the end to the war, there was an end to the accelerated government spending.

Inflation, Deflation or Biflation?

It is issues like government spending which fuels the debate between those who believe the U.S. is in a deflationary or inflationary cycle. Recent Federal Open Market Committee (FOMC) meeting minutes indicate the Federal Reserve fears deflation more than inflation, while those who go to a doctor, drive a car or eat food know inflation is omnipresent. So who is right? Perhaps both? While non-discretionary items like food and energy have seen increases in prices, discretionary items like homes and cars have experienced weakness, keeping the official inflation numbers in check.

Even the most non-objective observer realizes how important it is for the government to keep a lid on inflation. This CPI number affects how much payments on programs indexed to inflation such as Social Security, Medicare, Medicaid, and interest on U.S. Treasury obligations will increase. But thanks to the Bureau of Labor Statistics’ (BLS) ever-dampening CPI numbers, a type of “back door” inflation has been created, easily seen through the deterioration of the U.S. Dollar versus other currencies and the meteoric rise in the price of most commodities, including gold. This phantom inflation is definitely felt in the pocket books of the average American as the cost of food – as measured by the Commodity Research Bureau (CRB) Foodstuffs Index – has gone up a whopping 7.02% compounded annualized since 2000. This means the loaf of bread you bought 10 years ago at \$1.77 is now \$3.50. Using the cost-of-living adjustment suggested by your Social Security payment, or 2.45%, the cost of this same loaf of bread should be only \$2.26. Quite a difference. The following chart is a sampling of the inflation in actual commodities versus the CPI calculation produced by the BLS.

Tinkering with CPI?

The government reports inflation based on a Consumer Price Index (CPI), a time series measure of the price level of consumer goods and services. Their data suggest inflation has been tame for the past 10 years: \$100 in 2000 still maintains equivalent purchasing power of \$78.34, a compounded rate of inflation of approximately 2.45%. However, the Bureau of Labor Statistics (BLS) has changed the methodology used to calculate CPI significantly since the early 1980’s, and since 2002, roughly once every two years. Based on an older CPI methodology of calculation, John Williams of Shadow Government Statistics (www.shadowstats.com) says CPI has really risen by a compounded annualized rate of 9.1% over the last 10 years, meaning \$100 in buying power in 2000 has actually eroded to only \$41.07.

For Decade Ending Jan 1, 2010

	Compounded Annual Rate of Increase	Source Method of Measurement
Food	7.02%	CRB Foodstuffs Index
Industrial Metals	12.09%	CRB U.S. Spot Metal Index
Gold	14.30%	Gold Spot Price
CPI	2.45%	Bureau of Labor & Statistics
CPI	9.10%	John Williams' Shadow Government Statistics

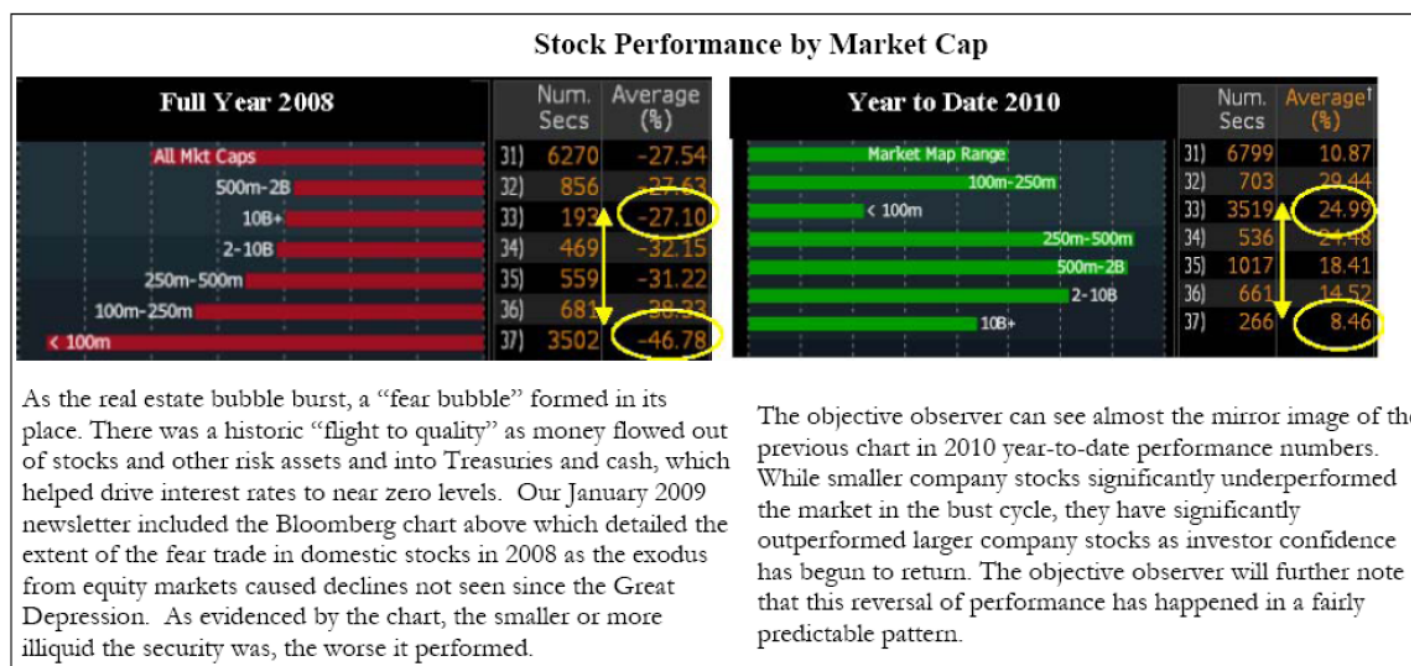
So why would the Fed be more concerned with *deflation* than *inflation*? The answer is fairly long, but simple. The deflation investors have just experienced in asset prices on a broad basis has caused a flight from risk capital; risk capital is a key component of job creation; investors are less willing to risk any more capital in a marginalized investment environment, further accelerating the slide in asset prices; this hesitation on the part of investors prolongs unemployment and stifles job creation; and ultimately, further loss of jobs is the issue, we believe, in which the Fed is most concerned.

This phenomenon of inflation and deflation occurring simultaneously is a newly-minted economic term called “biflation.” The theory states that increasing or high unemployment fosters the decline in purchasing power. Commodity prices rise which in turn dips into consumers’ discretionary incomes for items such as homes, cars and even financial assets.

Biflation is a dangerous concept because it involves the harmful kind of inflation and the harmful kind of deflation. Not to oversimplify, but not all inflation and deflation are necessarily bad. For example, inflation due to a deteriorating currency can be ruinous, but inflation driven by real demand for goods and services can be healthy. A moderate level of this right kind of inflation provides corporations with some ability to raise prices. Increasing profits thus attracts risk capital, potentially leading to higher employment, increasing wages and overall real growth in the economy. Likewise, deflation in prices, due to efficiency and productivity gains, are beneficial to a point, but when companies lose the ability to increase prices above the cost of production, deflation can lead to lost output and reduced payrolls.

Unwinding of the Fear Trade

The same steps required to unwind “biflation” are necessary to uncoil the “fear trade” that has existed for the past couple of years. The incipient stages of the cure can be seen in stabilization of home prices as the result of the absorption of inventories, the deployment of new capital by corporations, and a decrease in unemployment. Some investors argue the aforementioned are merely bounces off of the economic bottom which inevitably happen after such a sharp decline. Regardless, in order to extend the gains the economy has made into the future, there must be a new found sense of fiscal responsibility on the part of political leaders, both in Washington and in our communities.



There is overwhelming evidence the fear trade is unwinding. Money flows across all asset classes tell the same story. In the past 15 months, money exited safe harbors such as money market funds and Treasuries into high-grade

bond funds, and more recently, into stock funds. Money market funds have been reduced from \$3.9 trillion in January 2009 to just under \$2.9 trillion on April 22, 2010, while domestic equity funds have experienced net inflows of nearly \$11 billion in just the last five weeks according to the Investment Company Institute.

The market provides signals on a daily basis and the “quiet data” points to a potentially favorable environment for investors in the future. However, investors remain deeply concerned about the unsustainable nature of U.S. government spending and the resultant debt burdens. Thomas Jefferson stated, “I, however, place economy among the first and most important republican virtues, and public debt as the greatest of the dangers to be feared.” Businesses, large and small, will continue to be cautious about committing capital and resources due to the uncertainty about the future. If these issues are properly addressed, a multi-year economic expansion can ensue; if not, investors will be the first to comment on the “emperor’s new clothes.”

Sincerely,



Chris L. Doucet
Chief Executive Officer

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