Dear Investor:

Fertilemind Capital Fund I returned 21.99% in 2010. Given my bearishness at the start of the year, I must admit to being pleasantly surprised by the year's returns.

In my 2009 year-end letter titled "Childhood's End Again," I expressed skepticism at the ability of the American government to reignite its economy without causing dramatic weakness in the U.S. dollar. I thought the appropriate response was to move Fertilemind Capital's U.S. dollars into currencies run by fiscally responsible governments from countries with vast natural resources. I originally thought that with everything else being equal, the currencies that did not need to have their supply expanded should do well. After all Bernanke, following Keynesian prescriptions, was conjuring up U.S. dollars and handing them out at nearly no cost.

But, worried by extreme capital inflows from the Bernanke dollars, other governments joined in the mass-currency creation. The result? Over 1.5 trillion in U.S. dollar equivalents were manufactured and dumped onto the world markets. When Guido Mantega, finance minister of Brazil, declared a currency war I realized that any fiat currency was fraught with risk. This was an odd war as the combatants thought that the weaker you were, the more you were likely to win.

Betting on one combatant over another was a fool's game. The best course was to sidestep the war altogether.

Re-evaluating Gold

I had not originally allocated much capital to gold. I was trained as a value investor, always looking at earnings to value an asset. Then I attended the New York Society of Securities Analyst Gold Forum and listened to a presentation by Bill Tehan, executive vice president at Mahler & Emerson. His ideas helped me realize that a value investor could analyze gold.

"Gold *is* money," he said, noting that gold has been a reserve currency for millennia. He compared that track record to the short time the unanchored U.S. dollar has had its reign. He did not understand how investors could say that gold had no inherent value. There is value in standing as the only asset perceived as money since the start of recorded history.

If gold is the only asset that has always been money, then I could analyze it using conventional value investing tools. Gold has an unbelievably large moat. The most powerful governments in the world have tried to surmount the moat by endorsing competitors. But gold still stands as the only currency that cannot be debased.

This is not a widely held belief amongst market participants. They believe that you hold gold when there is inflation. Inflation, in turn, is solely determined by the Consumer Price Index (C.P.I.). According to the C.P.I., there is currently little inflation so the recent increase in gold's price is therefore irrational. Few market participants seemed to think of inflation as a decrease in the purchasing power of the dollar in relation to other currencies like gold. But a permanent increase in the price of gold was certainly inflation in a very practical sense. You can buy fewer things with your dollars than with your gold. It is an idea that the Keynesians did not consider.

I started to gain confidence that my suspicions of Keynes, and my sense that his theories were held as truth by both the right and the left, was the competitive advantage that I had been looking for since my 2009 year-end letter. The question became: How long can this competitive advantage last?

So I questioned hedge fund colleagues about their confidence in money printing and their dismissal of gold. They saw it just like other downturns – an exogenous event impacts consumer confidence and the Fed comes in, lowers rates, and consumers start spending again. They would remind me that at the bottom of every downturn someone prattles on claiming "this time is different". So what is different now, they asked me. Why will money printing not work this time when it has worked since the time of F.D.R.?

Here is my answer, divided into two parts:

What is Different

The difference was no one examined these downturns as a group. Each of these downturns was the result of a bubble brought on by actions intended to stop a previous downturn. Unfortunately, each time, a more severe weakening of the dollar was required to get the economy inflated again. In 1992, the Fed reduced rates to around 3% for a year, bottoming at 2.92%. In 2002, it reduced them to around 1.5% for two years, bottoming at 1.00%. In response to the 2008 global financial crisis, the government purchased equity in the largest banks, guaranteed their debt and also had to bring down interest rates to near zero for three years now, with an interim bottom of .11%.

Meanwhile, the dollar has lost 76% of its purchasing power in relation to gold. It took $344 in 1992 to buy an ounce of gold. At the end of 2010 it took $1403 to buy an ounce of gold.

But the Keynesians do not want to stop the weakening there.

Recently, the Wall Street Journal asked a few respected economists how Bernanke should further stimulate the economy. Willem Buiter, chief economist at Citigroup, proposed that the US government should "mak[e] [currency] subject to an expiration date," in order to intimidate gun-shy consumers to start spending again.

For decades central banks around the world strove to convince their citizens that the paper money they issued was as good as gold, but now some are contemplating the sorts of tactics that, until recently, were buried in the fine print of gift cards.

Why it is Different

Seventy years ago when John Maynard Keynes, a man knighted by the British monarchy who also possessed left-wing bone-fides advanced a theory, the working man took it to be fact.

The right-wing was originally startled by some of Keynes' more sweeping statements, which showed a lack of respect for the market's ability to price assets. When he stated "without government intervention interest rates are almost always too high", it was clear that he thought inflation beneficial. Yet, when he looked forward to a time in the near future when "the government [would] suppl[y] an inexhaustible supply of capital [so that] borrowers should not have to pay interest or businesses a dividend" he seemed not to understand the possible repercussions of an economy that relies on constant increases in prices and decreases in returns.

After post-war growth widely attributed to Keynes, the right-wing had a change of heart. The Committee for Economic Development, a U.S. business organization, came up with something called Commercial Keynesianism, which relied more on tax cuts than social spending. But they agreed that deficit spending be encouraged and that the government should control interest rates. None of the proponents of Commercial Keynesianism realized that a dollar of debt incurred by tax cuts showed on the government's balance sheet in the same red ink as a dollar of debt incurred by social spending.

Eventually, debt, no matter the cause, must be paid back.

But the temptation of a free lunch was too alluring. So when forty years ago, President Nixon declared that "we are all Keynesians now," it proved there was a consensus amongst the political and economic leadership for deficits in the budget and debasement of the currency.

But the Internet is allowing skeptics of Keynes to collaborate and attack ideas that are accepted as fact, even though they are advanced by those with an impressive social or political title. The Internet just makes it too easy to find and share information to allow a theory as faulty as Keynesianism to survive. With one click, you can read the speech that gave Bernanke the sobriquet "Helicopter Ben". With another, you can hop over to the blog of Nobel prize winner Paul Krugman, where you see him demonizing anyone who wants to create a system where people work for their income and do not subsist on the public dole.

But it is not just the traditional Keynesians who are revealed as flawed. The Commercial Keynesians are also exposed. You can click over to Youtube and learn that right-wing Harvard Professor Martin Feldstein recently announced that a way to end the recession was to borrow money and spend it on armaments, despite the 75.86% increase in real military spending in the last ten years. He seemingly forgot the admonishment of one of the most popular Republican presidents in history, Dwight Eisenhower, who advised that "every gun that is made, every warship launched, every rocket fired signifies, in the final sense, a theft from those who hunger and are not fed, those who are cold and are not clothed."

Increasingly in blogs you see hard-hitting criticism of these "economists from across the political spectrum" who all agree that the debasement of the dollar is the free lunch that people have been looking for ever since alchemy was debunked. Indeed, I did not even find the Buiter op-ed in the Wall Street Journal (it was only printed in the European edition) but on a blog Mish's Global Economic Analysis. In that post, Mish railed against Buiter's insistence "that something needs to be done":

> *Willem Buiter starts right off the bat with a false premise that "something needs to be done . . . [The] reality of the matter is that left alone, prices will fall to the point where genuine demand picks up. This is a fatal fundamental flaw at the outset."*

So much of Keynesianism relies on the supposed benefits of having a central banker "do something." This usually just means flooding the markets with liquidity. That was enough to get people spending again in the pre-Internet "he said /she said" media world of quick sound bites. In that environment, where economics was lucky to get ninety seconds of a twenty two minute newscast, the viewer was led to believe that the only two possible options to revive an economy were tax cuts or social spending.

In the Internet era publishing tools are available to everyone, and readers can find a whole variety of arguments. For instance user "patientrenter" on Calculatedriskblog.com hinted at some of the costs of these constant floods of liquidity when she wrote:

> *Money has exactly two functions. It facilitates the exchange of goods and services over distance and time. The ideal currency is one which would have the same value 5000 miles away, or 50 years from now. All this fuss over how we need some inflation for our economy to work well is puzzling.*

For too long, people have tolerated this inflation because they were comforted by the belief that central bankers had developed a predictable discipline out of something, monetary economics, that should be ever-changing. The bookish language used by Keynesians further served to give people the idea that these were all-knowing professors just implementing a proven mathematical formula. But the Web has made it easy to piece together the tools used by central bankers to re-inflate bubbles. It turns out the tools are a lot more primitive than people thought.

In a post on Mises.org titled "Will There Be QE3, QE4, QE5...?" Philip Bagus details the importance of Bernanke's use of the pseudo-scientific phrase "Quantitative Easing", as a key element in creating a "smog to hide" what is a simple debasement of the dollar.

> *Consequently, QE2 is, despite Bernanke's words, inflationary. In fact, it is a euphemism to call the policy QE2. The term quantitative easing conceals the true inflationary nature of the instrument. Furthermore, it sounds technical. The added number "2" makes it even more so. People who know little about economics might ignore news on QE2. Why bother to understand something so technical — let the experts deal with it. The term also has a positive connotation. Who does not want 'ease'?*

Keynes' theories on how to motivate consumers to spend during a recession may have worked for several generations, but now the end point is near. People whose behavior is being predicted always try to game the predictors. The Internet, allows those being gamed by Keynesian economists new tools to help figure out the predictors' weaknesses. Because of this free flow of information on the Internet, Keynesians, with their borrowers who do not need to pay interest and their companies that do not need to pay dividends, will have difficulty trying to stimulate the next bubble. As markets recognize this notion, gold should increase in value compared to man-made currencies.

And What does that mean for Equities?

I have met with management teams from solid tech companies over the last year. When I sit down with them, they often tell stories of frustration; how can they thrive in an environment that is so much different from when they grew up as businesspeople (usually in the 90's)?

Most quote an email, written by Steve Ballmer, in which he directed his staff to adjust to "something called 'the new normal.' After years of economic expansion fueled by unrealistic rates of consumption and unsustainable levels of private debt, the global economy has reset at a lower baseline level of activity. Today, people borrow less, save more and spend with much greater caution." They don't care about lectures on the end point of Keynes, but they do understand that there is a 'new normal.'

They sense the previous period of bubbles and blow-ups is nearing an end, but how can they thrive? The answer to that question leads me to the strategy that I will be pursuing in addition to traditional value investing. I call it Merchant Banking for the New Normal.

Merchant Banking for the New Normal

These management teams all have profitable companies with years of real profits. Yet the market is ignoring them because they do not have the liquidity or the world-changing product line of a company like Google or Apple. But if these companies simply returned their profits to shareholders, those investors would receive dividends of 7-10%. This is approximately 4x what companies like Google could offer if they decided on the same strategy. It is 6x the current dividend of Russell 2000.

If they did dividend the free cash flow out at that rate the shareholder's returns on dividends alone would be in the top quartile of all hedge funds. As a result, I have started to offer the companies this proposal: Unless there is a specific reason to use the free cash flow the company agrees to dividend out most of its free cash flow going forward.

Fertilemind Capital agrees to invest up to $5 million in the equity of the company at a price so that the company will yield approximately 7.5%. Fertilemind Capital will invest that amount even if that means that Fertilemind Capital must offer a third party tender in the public market at a substantial premium to current market prices.

My hope is that once the company commits to the strategy of dividending out free cash flow the discrepancy between the dividend yield of the target company and the broad market indices of 1-2% will be reduced. But even if the difference does not reduce dramatically, both the company and Fertilemind Capital benefit. The company gets a much higher stock price that makes acquisitions less dilutive while Fertilemind Capital gets a low-risk way to earn above-market returns.

The Lucrative Paradox Of 2011

Both strategies -placing a portion of our assets in bullion related securities and working with companies to return their free cash flow to shareholders- are born from my grounding as a value investor and hold a common theme. I am calling it the Lucrative Paradox of 2011. Those who find innovative ways to reduce risk will be the ones who produce superior returns.

Please let me know if you have any questions.

Regards,

Aram Fuchs