**THE BIG PICTURE FOR 2013**

**THE CRYSTAL GLASS IS HALF FULL**

IT’S STILL TIME TO BE INVESTED IN EQUITIES, ESPECIALLY IN U.S. BASED MULTINATIONAL COMPANIES that have decoupled from just being part of the U.S. economy. These “flagless” corporations can earn increasing profits thru expanding sales offshore in the emerging countries such as Asia, Latin America & Africa. Some of these countries are less leveraged and have more rapidly increasing per capita economic growth than the developed countries. Many of these multi-national companies have also “right sized” themselves domestically by adjusting to lower U.S. GDP growth & wage increases, while benefiting from cheaper labor & taxes abroad.\(^1\) Meanwhile, total manufacturing in the U.S. has almost come back to where it was prior to the beginning of the Great Recession. U.S. productivity in the last 20 years is up over 50%. These companies are producing as much as or more than in the past, but using far fewer people to do the work. To cite an example: In the last 200 years, farm laborers went from 80% of the workforce to now just 2% but agricultural productivity increased 16 fold.\(^2\)

**ADD TO THIS SCENARIO A HUGE DOSE OF QE INFINITY** with the Federal Reserve’s potentially unending buying of mortgage backed bonds and treasury bonds. That’s flooding the world with liquidity and lower interest rates. This money has to go somewhere. As the Fed prints, it also puts downward pressure on the dollar, making U.S. goods more competitive to global importers. HOWEVER INRESPONSE, other countries must then print to devalue their currency in order to avoid loss of trade competitiveness. So the central banks of the world have been exploding their balance sheets at 16% compounded annually over the last decade.\(^3\) The world is becoming flooded with freshly printed money seeking returns, higher than what’s offered by government bonds and cash. Over time, stocks should be a recipient of this positive redirected flow as returns on “fixed” investments become less.

**THE TECHNOLOGY DRIVEN DEVELOPMENT OF MASSIVE RESERVES OF SHALE GAS AND OIL SANDS** meanwhile holds out the surprising prospect of North America becoming energy independent.\(^4\) We have at least 1000 years of carbon energy reserves (oil & gas &) in the U.S. alone in a stretch of vacant land in Utah, Wyoming and Colorado. These states may hold more recoverable oil than all the rest of the world put together, perhaps 3 trillion barrels. 30-60% of oil in the shale in that (Green River) formation can be recovered\(^5\) thru improved technology. This would become a game changer for the U.S. balance of trade.

**MEANWHILE, ABOUT 70% OF CORPORATE EARNINGS ARE PRESENTLY BEING RETAINED** and added to cash piles on balance sheets.\(^6\). There are not many opportunities for reinvestment of this cash into the businesses due to excess capacity and general business caution. However, there are 3 possible alternative uses for these cash hordes: 1) more

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\(^1\) Barron’s

\(^2\) Thoughts from the Front Line, John Mauldin

\(^3\) Natl Numismatic Association

\(^4\) Wellington Letter

\(^5\) Barron’s

\(^6\) Barron’s
dividends, 2) more acquisitions, 3) more stock buy backs. For example, a typical company could buy back 5% of its shares, *thus* reducing stock supply and increasing demand for the shares. Dividends are usually reinvested into stock as well, unless used for investor current income purposes. This is favorable for both the increase of demand for and the shrinking of the supply of equities.

**HIGH DIVIDEND STOCKS** are another of our favorites, as these have recently gone “flat line” over the last two years or so, as compared to the large cap market averages. Over the prior 10 and 20 years, investors have received sporadic outperformance from these stocks as income becomes the operative word for retiring investors. The thunder of the retiring herd is just now starting to be felt. However, in anticipation of tax increases on dividends in 2013, these stocks were sold off as the “fiscal cliff” approached.

**A DIVERSE PORTFOLIO** of pipeline, energy, MLP’s, business development, mortgage REIT’s, other mortgage investment firms and telephone companies can yield in excess of 6% annually and often much higher. I ask myself: would I rather own a high yield bond (without any asset backing) at 6-7% interest that may not be able to be paid off at maturity, or own company equity whose revenues and profits (and probably dividends) are likely to increase with inflation over the next 5 to 10 years? These high dividend stocks may not keep up with the industrial average every year, but *our experience* has been that these cash cows have *far exceeded* the averages over the longer run (track record available upon request). If we can put on a “Buffet Bonnet” (Warren’s hat) we’d become giddy (like him) *if the stock goes down after we own it*. We can then buy more shares with our cash in under-performance years. But if we were to put on the average investor’s hat, we might abandon this cash cow space if it performed less than the index for a period of time. Actually, we’d all probably like and benefit from the Buffet Bonnet more, once we really think it through.

**RECENTLY A TELEPHONE COMPANY** stock went down about 25% due to emotional and momentum year-end selling. It was priced to pay 12%/year in dividends. I couldn’t help but want to buy a 1%/month on average dividend of the company that serviced my mountain home for the last 30 years. I can live with that return. I now hope it goes down to where I might even get a 15% dividend on additional purchased shares. I’ll probably buy more, if I can keep my Buffet hat on while around me others may be losing theirs, and selling in the emotion and momentum of the “it’s not keeping up with the averages” crowd.

**THE RETURNS OF THE AVERAGES HAVE BEEN ILLUSIVE, “HERE TODAY, GONE TOMORROW”** for the last 14 years or so. The S&P index was in the 1400’s in 1998, and is still in the 1400’s today. Even if the hi-dividend stocks were still priced the same as 14 years ago, the dividends alone at 6-8% or more have allowed for a lot of reinvestment by *compounding* the number of shares, resulting in even more cash flow. And then just what is the seller who fears increased taxation going to do with the proceeds? Put them in cash? Bonds? Interest is also taxable unless it’s municipal interest. So, if we can put on our B-Bonnet, we might agree. Yes, we’d buy stocks with 6-8% dividends and *even more* if they decline, especially if we need income. Future dividends for these special cows should continue to grow, as the *fixed income* return alternatives become less attractive.

**REAL ESTATE, TOO, SEEMS TO HAVE TURNED THE CORNER** for now, helping to fill the investor’s glass perspective. There has not been as much home building in this recovery as in prior recoveries. Thus rental real estate occupancy already has increased and the rents have gone up. There are still 3-5 million houses of the 50 million homes with mortgages that are or could soon be for sale from foreclosure processes. 11 million homes are “under water” (mortgages higher than the homes’ value). Since the average home price fell by 1/3 from the 2006 peak, it will take a 50% improvement to get back to the ‘06 high water mark. Low interest rates have helped push the median sale price back up to approximately $190,000, that’s about 10% above a year ago. The inventory of currently listed unsold houses is just two million, or about a 4.8 month supply.

**HOME PRICE IMPROVEMENT AS WELL AS HIGHER STOCK PRICE LEVELS HELP INCREASE THE “WEALTH EFFECT”**. As people feel richer, they spend more. Patient investors owning quality businesses (stocks) are likely to be rewarded in

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the long run, despite near term uncertainties & potential volatility. Equities are also attractive from a relative standpoint, with the spread between the forward earnings yield on the S&P and the 10 year treasury yield standing above its average. This is similar to early 2009 and the mid 70’s, just before the beginning of major equity rallies. The equity advantage is now higher than during the oil crisis, Asian crisis, subprime crisis, and any crisis that took place in the last 60 years. With more money in bonds ($70 trillion globally) and cash ($11 trillion in the U.S. alone) looking for “downside protection, there is potential for a gradual global shift out of bonds toward sustained equity recovery (at present there is only $15 trillion in the U.S. stock market)”. “High quality, pristine balance sheet, high free cash flow-fielding businesses, which can weather a world of uncertainty, represent a relative oasis of safety from a balance sheet, business continuity and growth standpoint”. The risk aversion against equities may slowly start to diminish and a potential massive exodus from bonds over the next decade could propel stocks to much higher highs.

BUT THE CRYSTAL GLASS IS ALSO HALF EMPTY.

THE BOOM IN THE U.S. AND WORLD FROM 1982 THRU 2007 was in part the result of financial innovation and massive consumer & financial leveraging. That process ended with a bang in 2008. We came within minutes of total shut down of the U.S. banking system. After a 25 year fiscal and monetary expansion cycle, the world is now in the process of deleveraging and contracting. This unwinding can take years and isn’t something that will likely end any time soon. The central banks have already applied most of the tools of their trade to try to re-kick start the economic engines once again. The only real tool left is the expansion of the money supply (the old currency printing press). With U.S. annual deficits of over a trillion or more each of the last 5 years, the total outstanding U.S. Federal Government debt now exceeds $16 trillion. U.S. government expenditures are about 24% of GDP while tax revenues are only 17%. The ‘08 crisis was a debt and liquidity problem of just several financial firms. Now it’s entire countries that have become the next potential debt & liquidity crisis problem.

MEANWHILE, DELEVERAGING COULD MEAN LESS SPENDING, AND THUS LESS GROWTH, ALONG WITH LOWER INTEREST RATES & LOWER ASSET-PRICE RETURNS for a long time to come. The world GDP has gone from $32 trillion to $70 trillion over the last decade, but the global government debt necessary to produce that 10 year doubling of GDP jumped from $80 trillion to $200 trillion. So it took $120 TRILLION of added government borrowing to create just $38 TRILLION of GDP growth. That’s $3 of borrowing to produce $1 of added GDP.

OF COURSE THE REAL DEBT OF THE U.S. IS FAR GREATER THAN THE 16 TRILLION of outstanding treasury obligations (which alone is about 100% of GDP). These obligations also include the promised IOU’s of social security, Medicare, veterans’ benefits, government employee retirements which are all unfunded (with no money in the bank). These together exceed $100 trillion or about 700% of GDP (7 times GDP). If the Federal Reserve is now funding 70% of the annual deficit of over $1 trillion each year, how will it also fund the increasing needs when the entitlements promised the 78 million Baby Boomers kick in over the next 10 and 20 years?

NOBODY SEEMS TO WANT THEIR ENTITLEMENTS TOUCHED. They paid for it and/or they voted for it. Either way, it’s theirs and hard to take away. A recent example of a $10/hr. housekeeper ($20,000 in wages before payroll deductions) who was able to claim disability benefits (although she actually said she could have continued working) receives a check for $1500/mo., $700/mo. EBT card (food stamps), $800 rent check and 250 minutes free call phone. That’s $42,000/YEAR for a no work week. Do we think she’d prefer $20,000/YEAR for a 40 hour work week?

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8 Alkeon Capital Management
9 Alkeon Capital Management
10 Alkeon Capital Management
11 Barron’s
12 Gold Switzerland
13 Wellington Letter
THE POLITICIANS OVER PROMISED WHAT CAN NOT POSSIBLY BE DELIVERED. But the 50 million current U.S. Medicare recipients expect it to be funded somehow. There are two choices: increase taxes and/or print the needed money (The U.S. will be doing both in 2013). The Tea Party crowd has pledged “no increases in taxes”. Meanwhile, the top 1% of earners pay 37% of taxes; the top 10% pay 70%. 50% pay no tax. And so the standoff: The taxed vs. the untaxed & entitled... and taxing vs. printing.

WHERE ARE WE NOW?

AT 100-120% DEBT TO GDP, countries can still possibly pull themselves from the brink of sovereign crisis. It’s through a combo of austerity (spending reductions), restructuring (putting solvent financial institutions into receivership and altering the terms of unworkable private and public debt), and monetization (relief of public debt thru permanent creation of currency), says John Hussman (Hussman Fund). The U.S., now at about 100% of debt to GDP, will be closer to the 120% mark by the next midterm elections in 2014. Canada, Australia, China have all borrowed from the central bank in the past but have turned around in time with abrupt changes in fiscal and monetary policies. Natural resource exports and modified government regulation and controls have also been part of the turnaround process.

CAN ANY OF THOSE CHANGES now turn the fiscal balance of the U.S. in sufficient time? We might immediately respond with “drill baby drill” those untapped reserves to help solve our trade imbalance. But the millions (of people) promised trillions (of dollars) are lining up to receive their entitlements of social security, Medicare, veterans’ and government retirement benefits. Let’s hope we don’t have to add war expenditures with Iran or other countries on top of these looming demands. 35% of the world’s oil currently passes in the 21 mile wide Strait of Homuz. So, for now, that cut off would certainly not be a good thing.

THE U.S. IS STILL CONSIDERED THE WORLD’S “CLEANEST DIRTY SHIRT”, says Bill Gross of PIMCO. It still has the benefit of having the world’s reserve currency. But it is a serial offender, he adds: “an addict whose habit extends beyond weed and who frequently indulges itself in budgetary crystal meth”. Uncle Sam’s dependency habit is very hard to break. Then there’s Japan, Greece, U.K., Spain and France in the “rogue’s gallery of debtors” as well. Budgets that are currently considered to be in better relative control: both of our neighbors, Canada & Mexico, along with China, Brazil and even Italy.

SO WHAT IF MOST OF THE DELEVERAGING COUNTRIES JUST CONTINUE TO “PRINT BABY PRINT”? Rejecting austerity in order to reduce deficits, the U.S., Europe, Japan, China, & some countries in South America are seeing no other alternative but to print or perish. But almost no country really wants to hold another country’s long term junk (unbacked) government bonds, especially at current interest rates. The U.S. reserve currency is still considered the “go to” temporary cash park when it’s “risk off” time (flights to safety). The U.S. dollar has the biggest liquid market and dollars can still be used to purchase oil from some of the Middle East countries.

THE U.S. FED IS CURRENTLY BUYING $45 BILLION OF MORTGAGE BACKED SECURITIES EVERY MONTH (indefinitely until...unemployment reaches 6.5%?) and at least another $40 billion of long term treasuries (to “balance the deficit” and to help keep rates down to support the mortgage markets). Bank of America predicts the Fed will have printed a total $5 Trillion by mid-term elections (2014). Monetary history shows currencies under political control are always destroyed eventually. ALWAYS. Even the Swiss have now pegged their currency to the Euro in order to remain commercially competitive (meaning it’s printing enough francs to keep it at the level of the Euro). Meanwhile, the whole world searches for income and safety. But there is no income and ultimate safety combination, especially when measured against the effect of inflation from this global “monetization” (or printing).

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14 Fox News
15 Wellington Letter
16 Bill Gross
THE CENTRAL GOVERNMENTS SO FAR HAVE BEEN able to print money in amounts that in prior periods would have sent inflation spiraling upward. The U.S. Fed has printed more dollars since 2008 than all of its 93 years of previous history. But what about “velocity?” Are people actually spending this newly printed money? Not really. Velocity has been declining over the last 5 years. Also, this printing is being offset by the destruction of debt thru defaults, bankruptcies, and consumers cutting back in an attempt to reduce debt. So the Central Bank will likely be able to print a lot more money for a while before stoking much bigger inflationary numbers. And without the printing, we’d surely have deflation and depression by now, such as that experienced in Greece (where they can’t print their own currency).

MUCH OF THIS ADDED $5 TRILLION WILL FIND ITS WAY INTO THE STOCK AND BOND MARKETS. This helps keep prices elevated in the meantime, thus creating a feeling of “all is well”. And so we’ll just hopefully feel it’s OK for us to “spend baby spend.” In the “wealth effect”, we tend to spend more when we have home and stock market profits. Remember, printing is the last tool in the box. It means pushing money into the banks to bail out their previous irresponsible lending standards. But the banks are buying 1 ¼ - 2 ¾% treasury notes & bonds on leverage with ½% interest rate Fed loans, rather than once again risking their capital with consumer and small business loans. Meanwhile, big business, with bigger cash piles and better collateral, can get plenty of money from the bond markets at present, so it doesn’t need the banking system.

WITH THIS BIG PICTURE IN MIND, WHERE MIGHT THE LONG TERM SMART MONEY HEAD? Probably it sees the handwriting on the wall. If the central banks were to stop printing, it would be “Greeceville”. That could mean populations returning to the countryside to their old family farm homes from whence they came, to again raise chickens and milk goats, if they can find any. So, it’ll be more “crystal meth” for the governments with access to the money printing machines. That was the way of Germany from 1919 thru 1923 when it owed the reparations for WWI. With no inflation resulting at first, they just printed more and more until one day, the essentials (food, etc.) began inflating, while non-essentials were still deflating or flat (housing, cars, big ticket consumer items).

A GOLDEN PERSPECTIVE

IN GERMANY, YOU COULD BUY AN OUNCE OF GOLD (the ultimate currency for over 5000 years) for $160 marks in 1919. By Nov. 5, 1923, it took 8.7 trillion marks for an ounce of gold. By November 23, 1923, it cost $87 trillion marks/ounce17, up 10 fold in less than 30 days as consumer prices skyrocketed. From January 1920 to 1923, a $500 mark investment in stocks also did well, becoming worth $200 million marks18. Consumers bought tangible “things” immediately (and were often paid twice a day) before prices went up even further. Manufacturing & retail companies did well with backlogs from product demand. So stocks for companies that had something of tangible value to sell were also advancing, representing a better store of value. Cash and bonds were avoided & dumped as interest rates escalated to compensate for inflation. There was at first a gradual but then a more immediate loss of purchasing power, even if holders did get the “principal” power back at maturity. The note principal by the end of the five year period became worthless paper to be recycled or used as starters for firewood.

IF GOLD CONTINUES TO ADVANCE, as we suspect it will over the next decade (it’s been the best investment category for the last 10 years vs. cash, bonds or stock, even combined]), gold companies should benefit as well. Gold stocks have recently been a beaten down sector as hedge funds bought gold and sold short gold equities (resulting in profitable trades). The gold stock index on the NYSE of 16 mining companies had fallen approximately 20% in 2012 and a total of 40% since August 2011. These 16 stocks are now trading at an average 13 multiple to earnings compared to the 5 year average of 35 times19. The prices of gold shares are now below the value of their gold reserves20.

17 Cliff Kule’s Notes
18 J.P. Morgan
19 Wellington Letter
20 Wall Street Journal
GOLD ALSO HAD A 30% CORRECTION IN 2008 as there was a rush to find liquidity anywhere, and another almost 20% decline since the $1895 top in 2011. It’s up about 6% for 2012 while gold shares are still down about twice that amount. Gold is not a one way investment, but has averaged over 16%/yr. for the decade.\textsuperscript{21} This letter has been recommending a long term hold for gold since 2001. We’ll continue to recommend holding and accumulating on pull backs. Fortunately the central governments can’t produce gold by the click of a mouse as they can paper currencies.

GOLD HAS BECOME HARDER FOR MINING OPERATORS TO DEVELOP. Costs have doubled on average over the last 5 years for producing companies. Even though the top 10 mining stocks netted $68 billion in the decade ending 2011, they spent $89 billion or $20 billion more than net cash flow for corporate expenditures and acquisitions. Additional shares of the companies were sold to fund that difference (diluting existing shareholders). The easy gold has been found and produced. It will now take higher gold prices to get past the old earnings highs for these companies, and that is one reason for the current low P/E.

IF WE OBSERVE THE TREND IN THE PRICE OF COLLECTIBLES, such as diamonds or one of a kind original art, we see that long term investors with extra cash are looking to these types of tangibles that can’t be easily printed or multiplied by the powers that be. The U.S. says it has 261.5 million ounces of gold in its vault (unaudited)\textsuperscript{22} The U.S. M1 money supply is $909 billion and M2 is $8,764 billion. Divide those ounces of gold into the cash and you get $3,477/oz. for M1 and $33,514/oz. if you do so with M2 currency in circulation. Twice in the 20\textsuperscript{th} century, the gold value became 100% of the U.S. currency in circulation. It’s currently in the mid-teens percentage wise.\textsuperscript{23} More serious Investors with a sense of the history of gold start migrating to gold bullion when currencies no longer function as a store of value after inflation (i.e. 0% interest rates while “official” inflation is 2-3%).

AT THIS TIME ONLY 1\% OF INVESTOR FINANCIAL ASSETS ARE IN GOLD BULLION. There has been a lot of “paper gold” (not actually backed by bullion but rather derivatives) created in the banking system thru the use of exchange traded funds. This paper gold market can easily manipulate (suppress) the price of bullion on an intermediate term basis “if the shares are sold short”. Eventually these gold paper short positions will most likely have to be covered (bought back) and the real stuff may well be not sufficiently available. That’s when this sector could outperform even its last ten years strong performance results.

BONDS VERSUS THE BUFFET BONNET

INVESTORS HAVE GRAVITATED TOWARD THE FEELING OF MORE CERTAINTY WITH “return of our principle over the return on our principle” over the last decade. Sounds reasonable & logical enough at first. The stock market has had two 50% off sales, and that has been both disruptive and unnerving to those who “just want to hang on to what they got”. That too, on the surface, sounds reasonable & a worthy enough objective. After all, the “equity index” was at 1,400 on the S&P index in 1998, and near 1400 again as we write this letter in December 2012. The index (& general market) returns have been up and down, “here today & gone tomorrow”.

THAT’S WHY I PREFER TO BUY HIGH DIVIDEND STOCKS, like the telco recently paying 3%/qtr. (12%/year). I can actually spend that 12% (after any taxes) or buy more stock with it. A high dividend income portfolio (such as our Equity Income Portfolio) may not outperform the index in each and every year (it hasn’t the last two years, for example). But over the decade it’s more than tripled with dividends reinvested and increased a factor over 10 for a 2 decade period when augmented with hedging strategies (using inverse funds during market downturns). My “Buffet Bonnet” (hat) says go for the “bird in the hand” (big dividends) with income that has a reasonable possibility of keeping up with (increasing) inflation thru rising revenues and profits as prices of goods and services advance over the years.

\textsuperscript{21} The Economist
\textsuperscript{22} Rick Maybury
\textsuperscript{23} Guggenheim
BUT THE MASSES OF INVESTORS have instead poured a trillion into bonds since 2008, pulling almost ¾ trillion out of stocks. These investors may have missed much of a 100% rally recovery so far in stocks. And now, with interest rates near all-time lows, the principal is at risk in bond funds if (when) rates should begin to rise. Morningstar points out that long term, treasuries have had almost as many losing years (22) as stocks (24 years) over the last 85 years (since 1926) and fared much worse than stocks when adjusted for inflation (bonds down 33 yrs. vs. 28 yrs. for stocks).

IN 2009, AFTER STOCKS HAD BOTTOMED AND STARTED TO REBOUND, long term treasuries declined 17% after adjusting for inflation. 2009 was the worst year for bonds since Morningstar started keeping records going back to 1926. If interest rates were to rise by just ¼%, long term bonds could decline 4-6% according to Bloomberg. “Bonds can get burned to a crisp. Many investors don’t understand what can happen to their bond funds in a rising interest rate environment”, says PIMCO bond king, Bill Gross. “Losses from bond funds going forward may be worse than at other points in history when rates rose, such as in 1994 or late 1970”, says Ken Volpert of Vanguard Group. A 10 year treasury is currently yielding 1.75%. If yields rise to just 2.75%, investors will lose (-7.5%) total return, not adjusted for inflation. We have been in a bullish long term bond cycle, with 30 years of overall declining interest rates and positive bond price returns. Going forward, what has been a tailwind in terms of performance because yields have been dropping, could become a headwind as interest rates reverse direction.

NOBODY KNOWS WHEN RATES WILL ACTUALLY BEGIN A LONG TERM RISE (reversal of a 30 year downward cycle move). Be it the sudden appearance of a “black swan” landing on bonds or just natural causes, such as the continual possible downgrading of the credit quality ratings of U.S. treasuries due to increased deficits, we could experience a flight to safety to a different investment. We still advocate a bond allocation, but primarily a more monitored (managed) position where bonds with “inverse positions” (short position offsets) can be added to the portfolio as rates do begin to rise. We believe this inverse trade could turn into one of the most profitable moves when interest rates begin to rise in earnest.

SEVERAL NEWSLETTERS AGO (2009), we observed that the bumper sticker de jour was “Please God, give us one more bubble”. I think we got it, perhaps even two, one in bonds and another in currency creation (printing). The former is about as close to a high as it can probably get (how much lower can interest rates go), while the currency creation is likely just in its beginning stages. Following the investor masses (the herd) has usually not been a good means of preserving or growing wealth. It’s much better to be ahead of these herds when seeking better than average profits.

THANKSGIVING

THIS NOVEMBER WE HAD SOME WONDERFUL HOUSE GUESTS INCLUDING Peter and Lori Mauthe. Peter has been the talented CEO for John Mauldin’s enterprises over the last couple of years. (We’ve often quoted John in these annual newsletters. Mauldin is a longtime friend, who writes an insightful commentary on what’s going on globally.) Peter is beginning a new project in which he plans to hold several focus groups on “what investors want today”. When we have the opportunity to have investment professionals as our guests, we quite often try to find time to get into a side room for several hours to discuss “what’s next”. My longtime partner, Ron Miller, and our junior (8 year) partner, Josh Newman, were able to join us for this year’s session as well.

TO ANSWER PETER’S FOCUS GROUP QUESTIONS, I responded with a comment by a previous dinner guest who had sold his business for nine figures. “I’d just like to find a means of keeping up with inflation.” My response was, today with artificially suppressed interest rates, that can’t be a certainty. We use to count on official inflation plus 3% from our long term bond returns. Today we’re probably actually at minus 3% (i.e. T-bills at “ZIRP— zero interest rate policy”). You go “behind” by 3%/year. So we are forced to step out on the risk ledge to attempt to capture that 3% (after tax?) but with less certainty. However, if inflation is actually more than 3% (governmentsshadowstatistics.com suggests maybe 9.6% is closer), we must take more “risk on” to attempt to realize that higher real target objective.

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24 Bill Gross
“I INVEST TO MAKE MONEY, I DON’T INVEST TO LOSE MONEY” was another response from an investor. Just keeping what (investors) now have (preservation of capital) has become a “new normal” goal for many more nervous & aging investors. Again, T-bills (with ZIRP) are still the safest way for now for “preservation” of principal, but certainly not purchasing power. We need to multiply our cash account balances by the reciprocal of what we consider the real inflation to be. For example, if that inflation is believed to be 10%, then take 90% (your purchasing power after inflation) X your T-bill balances. Do so for the next year, and then the next, and so on. If you calculate the potential purchasing power of that “safe money” in 5, 10 years or over our own life expectancies, we can see that we don’t meet any of the above stated objectives by trying “to not lose” or have purchasing power certainty.

I SENT THE FOLLOWING TEN POINT CHECK LIST to Peter, shortly after our meeting. When he received it, he responded “That is AWESOME! I’ll insert it in the first sheet of my project notebook”. So, if you’ll permit me, I’ll share these TEN POINTS with you here to see if you might agree. These are “Evergreen” concepts as alluded to in our book The Evergreen Portfolio. If you can think of anything I missed or you’d like to see something changed, please email (or call) and I’ll pass it along for inclusion in this project. Who knows where this list might end up? For now, here are some important Evergreen points:

TEN POINTS

1. CASH, FOR EMERGENCIES – at least 6-12 months spending needs – in a safe insured place – with about 5-20% of our portfolio (with return OF rather than return ON investment as the primary consideration).

2. BONDS: FOR RELATIVE STABILITY (relative to the equity markets’) – about 15-30%; non-leveraged, no margin accounts; monitored on a daily basis for interest rate rises. We’re probably getting close to the end of the long term bond market super cycle and we should expect the possibility of significant purchasing power dilution over the next decade or more. Be prepared to tactically manage bonds with hedging capability (thru inverse bond funds).

3. STOCKS FOR POTENTIALLY BETTER LONG TERM INFLATION PROTECTION, with about 30-50% of the portfolio, seeking dividends and cash flow for spending or reinvestment, and with some global exposure consideration. Look for growth of revenues and profits to keep pace somewhat with inflation. Those stocks should be tactically managed with a bullish or an inverse equity fund overlay.

4. GOLD/SILVER bullion and equities for liquidity and possible inflation protection – about 10-20% - with some bullion coins stored outside the banking system.

5. A KNOWLEDGEABLE PROFESSIONAL available for questions on titling of assets, tax considerations (income tax deferral opportunities, estate tax minimization ideas, etc.) and tax sensitive investing, where appropriate. Investors should always check with their own tax & legal advisors, as well.

6. YEAR END SUMMARY for tax preparation, including tax lot accounting for all transactions.

7. AN UNBIASED RESEARCH SOURCE for bonds and equities.

8. EXPERIENCED FINANCIAL ADVISOR(S) with a long term track record of meeting the above expectations to help implement the investment strategy, allocation & management plan. Ongoing tactical asset management with competitive fees is recommended.

9. AVOID LOCK DOWN (CLAW BACK) POSSIBILITIES: no highly leveraged entities or commodity houses; use the least leveraged firms with little or no derivative/proprietary (in house) trading, but with a “customer first” orientation. No margin (cash accounts only) – in order to avoid co-mingling of assets with brokerage houses, unless it is necessary to
borrow money (a quick source of emergency funds). Seek SIPC accounts, which are insured against loss or theft of securities up to a certain amount. Look for transparency of investments (seeing what we own) with independent audits.

10. **FLEXIBILITY: THE TOTAL PORTFOLIO** is designed to be FLEXIBLE for either inflationary or deflationary trends (or both), constantly monitored, and hedged (when signals dictate).

**IN SUMMARY**

**HERE IS AN EXCERPT FROM CHAPTER 1 OF OUR BOOK, THE EVERGREEN PORTFOLIO,** Co-authored by Martin Truax and Ron Miller (2010 – Wiley & Sons)

So we need a workable plan, one that we might expect to accomplish our goals, despite an anticipated struggle with the deleveraging side of the long-term cycle. All of our liquid assets should be actively managed. Blindly buy and hold at your peril. Nobody gets it all right all of the time. Nothing wrong with being wrong. It’s part of the investments process. But staying wrong is what can destroy us. Preservation through preparation is our working mantra. Let’s actually plan and implement a strategy to survive and hopefully even prosper over our remaining years, and to also help benefit those people and causes we most care about as well.

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Gross Domestic Product (GDP) is the annual total market value of all final goods and services produced domestically by the U.S.  
The S&P 500 is an unmanaged index of 500 widely held stocks. It is not possible to invest directly in an index.  
REITs are financial vehicles that pool investors’ capital to purchase or finance real estate.  
MLPs are publicly trade limited partnerships.