

July 16, 2009

Dear Clients,

Much has happened in the investment world since my last letter to you six months ago. The recession we foresaw has indeed occurred and our government leaders have continued to react by assuring us they can “rescue us” by issuing mountains of debt and by taking over failed businesses.

### **A Political Economy.**

Ours is no longer a free market economy. It is what I would describe as a political economy or a government manipulated economy. That is, our government is intent on gaining more power by subsidizing or taking over the failures of our economy. Our government has become an owner of banks, insurance companies, auto companies, etc. They will now move to subsidize businesses, industries and products that meet their moral agenda (e.g., green products) and punish those that do not (e.g., cigarette makers, oil companies, etc.).

### **Investors on the Sidelines.**

Government involvement in the economy creates significant distortions that make it difficult or impossible to analyze a business or industry for potential investment. As a result, wise investors keep their money on the sidelines. This occurred in the 1930’s when FDR “experimented” with government programs to lift the nation from the depression. Every month saw a new program. Investors could not anticipate where the big hand of government would strike next to “rescue the economy,” so they stayed out. As a result, the investment capital necessary to increase production stayed on the sidelines and the depression lasted a decade.

History is about to repeat itself. Once again our government rides to the rescue with a magic bullet. They borrow money and print money so they can stimulate the economy and rescue selected businesses, while threatening to increase regulation on others. As our government brings “change” to our economy, investors will wisely stay on the sidelines to see how this “change” will impact various investments. As a result, our economy will stumble along just as it did in the 1930’s.

Although we might see an uptick in economic activity resulting from the stimulus, I expect any such good news to be short lived. The massive addition of government debt will result in increased interest rates, which will stall any economic growth. Inflation will rear its ugly head and we will stagger under the mountain of debt we have incurred.

### **Where to Invest.**

So what is a wise investor to do? Should we cash out and put our money under the mattress? Should we buy the traditional safe haven (government bonds)? Should we just give up and



spend everything we have saved? No. For every new twist in the economy - for every new danger that presents itself - there is always a way to protect you assets – and profit.

**For those of you in retirement** who are living off the proceeds of your investments, I've had a very busy year making changes to your portfolios. Most of the high-dividend producing businesses in the U.S. have seen their financial health come under pressure – and thus many of their dividends have been cut to preserve their balance sheets. In anticipation of this, I moved out of these companies in November and December of 2008. In addition I moved out of our bond positions in anticipation of higher interest rates – which have just started to creep up. Where did I reinvest your funds?

For those in retirement, your biggest position (approximately 50%) is now in Treasury Inflation Protected Securities Bonds (TIPS). Unlike other bonds, the coupon payments and underlying principal of these government-backed securities automatically increase to compensate for inflation as measured by the consumer price index (CPI). In other words, as inflation and interest rates rise, so do the returns on TIPS. TIPS are currently yielding 5.13%.

The next largest holdings are in two oil and gas limited partnerships, Kinder Morgan Energy Partners (KMP) and Energy Transfer Partners (ETP). These securities yield 8.4% and 9.2% respectively. As limited partnerships they do not pay taxes and that is why they have such high yields. They pass the earnings on to you pre-tax. I have been analyzing these limited partnerships for several years and have been reluctant to invest in them because of their unique tax implications. But the dividends are so robust that I decided to test these investments by purchasing them for my own account last year. Much to my surprise, when I met with my accountant at the end of the year to review the tax impact it was a non-event. Only then did I feel comfortable investing your funds in these companies. Just be aware that this is a unique tax creature and proceed accordingly. If you have questions or concerns about this investment please let me know.

The remainder of your investments are centered around businesses involved in commodities and real assets. During periods of high inflation these types of businesses and assets do quite well.

**For those of you not yet in retirement** we continue to seek ways to build the value of your portfolio. You will find that your investments are now heavily weighted in commodities such as gold, gold mining stocks, silver, basic commodities, and businesses involved in commodities. We've also taken positions in a mutual fund of Chinese businesses, and major domestic exporters of seasoning and seeds.

Why are we invested in these unique assets? Because I believe they will do very well in a high-inflation environment.



## Summary.

These client letters are important for you to read and understand. Unlike many investment managers, I do not diversify client assets across all asset types and hope for the best. I tend to concentrate in a few asset classes, depending upon the economic circumstances, to protect the safety of your retirement funds and to reap rewards where I believe they will be found. You may not be comfortable with this approach. If so, please don't be shy about letting me know. I will help you find another investment manager or a broad-based mutual fund that suits you.

As you can see, the past six months have seen significant changes in our investments to reflect an entirely different economic reality and in anticipation of some rough seas ahead. For a more detailed analysis of where I see our economy going, please review a document located on our website [FIInvestments.com](http://FIInvestments.com) entitled: Economic Outlook – 2009.

Clayton R. Smith