Capital Drain

Rick's investment opinion newsletter October, 2010 v.6 no.3

Before printing, think about the environment

Hi Readers,

I've had a bad case of "next week we'll know more and the new info will make the newsletter more interesting/accurate/etc." Of course, each week new questions have popped up. Have I really not written since March? Yipes; it is true. I apologize for the long silence.

Actually I have written a bit, but in web log form (one topic per entry) roughly weekly. These posts have had little info on investments I like, but more discussion of economics and policy.

I'm curious. Are you, the readers, interested in getting little bits of commentary, but more often than monthly? If so, you can follow the blog, "The Rigger's log," directly at www.LongspliceInvest.com/ricksblog simply by checking that website from time to time. For the more technologically fluent, you can click one of the 'Syndication' links on the page to get this (and other blogs, if you wish) automatically gathered and presented for you.

For the least fluent, or those who don't want to see their world only through a web browser, I can arrange to have each blog post emailed to you. Let me know if you'd like to be on this blog-specific mailing list.

In my opinion:

Executive Summary:

- The economy ***is*** getting better, but with current policies it's gonna be slow.
- Bonds had a good run, but it's probably done
- NOT gold
- Stocks with dividends could be the best bet for now.
- It's Credit Report time again! This time, TransUnion.

Tech stocks on the NASDAQ have had a pretty sprightly recovery. Most of those are nice companies, but the prices reflect high continued growth expectations. If you're holding shares of any of the conspicuous high-fliers, you might consider selling them into this bounce. It is safer to risk gaining a little less rather than risking losing a lot more.

This is a good time for investors to be conservative, to be in the best of securities: stick to value, to safety, to short maturities (for debt), and call me to chat if you're concerned about anything you're holding.

Above all, avoid the investments that are at all-time extreme valuations: junk bonds, developing-country bonds, and headline-grabbing stocks with high P/E ratios.

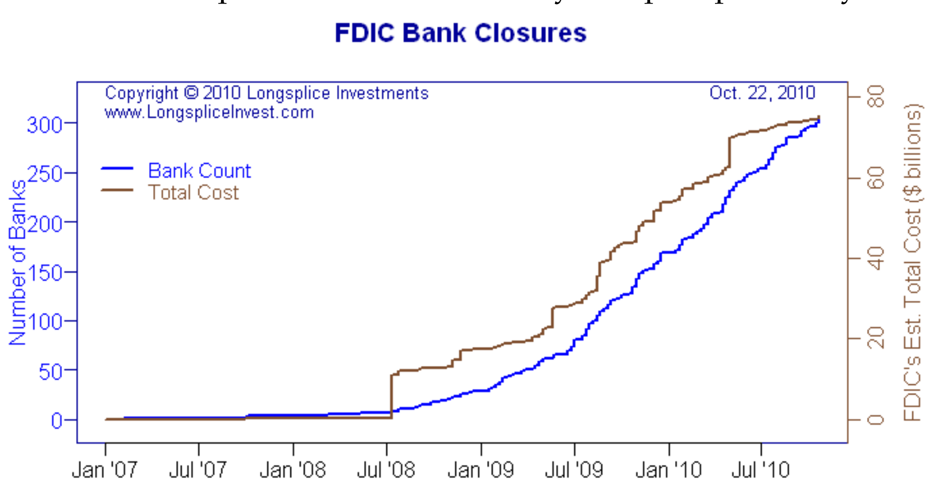
The Details:

> [The] typical error most countries make coming out of a financial crisis is they shift too quickly to premature restraint. You saw that in the United States in the 30s, you saw that in Japan in the 90s. It is very important for us to avoid that mistake. If the government does nothing going forward, then the impact of policy in Washington will shift from supporting economic growth to hurting economic growth."
>
> --Timothy Geithner on risks to the U.S. economy[1]

Sorry to start the letter on such a grim note. I think Geithner's right, but there is also real positive news to share.

The economy truly is getting stronger. There is negligible chance of a "double dip" return to recession before we've recovered. On the other hand, the recovery is slow.

The crisis part of our recent history was precipitated by bank failures. The worst is past, although there's still some mopping-up. As you can see, the FDIC's cost per new bank failure has leveled off, even though the rate of new failures is steady. The typical failing bank is now smaller, or less deeply in trouble, than back at the worst of the crash. That's a good sign; the ripple of disturbance from new bank closings is getting smaller.

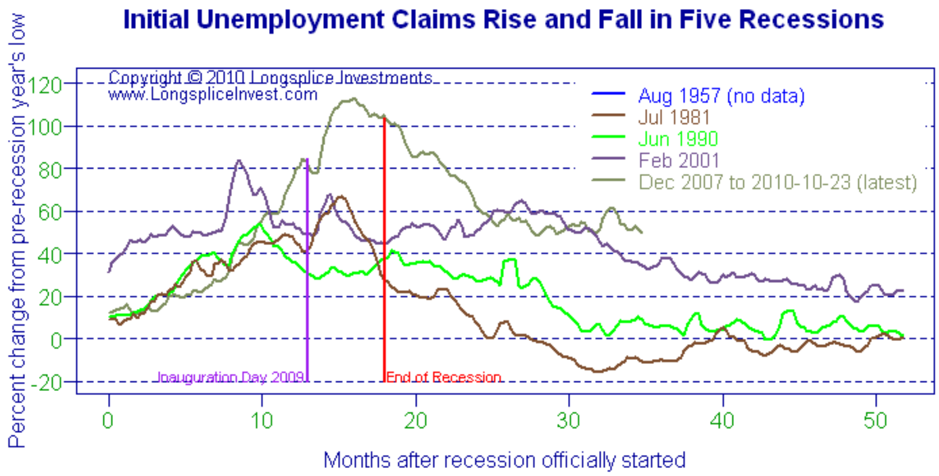


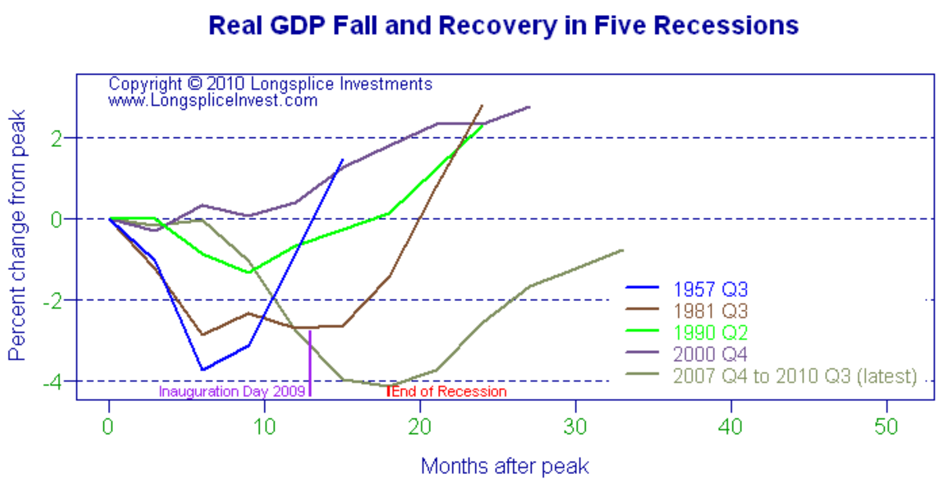
1 Deborah Solomon, "Geithner Urges Action on Economy," The Wall Street Journal, 12 Sept 2010, Dow Jones & Company, 12 Sept 2010, <http://online.wsj.com/article/SB10001424052748703897204575488053602454926.html>.

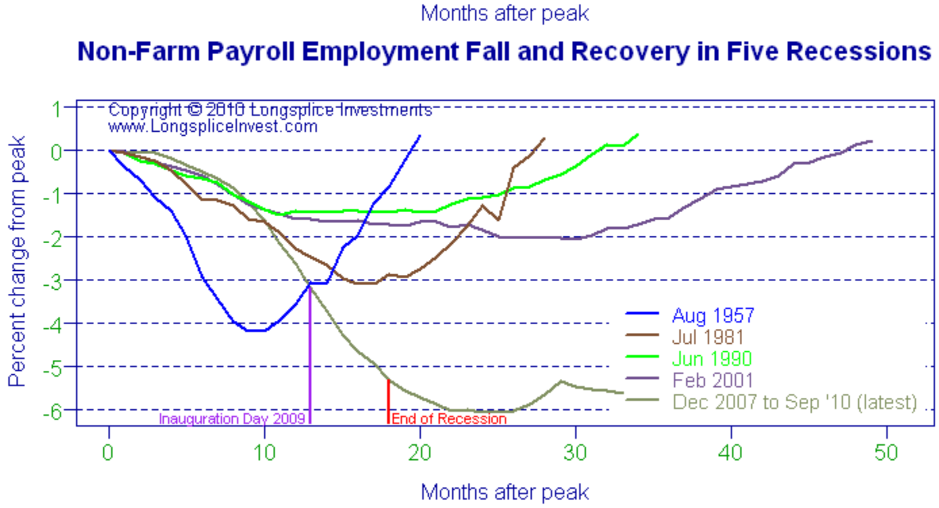
Meanwhile, by some measures the economy is definitely recovering nicely. New weekly unemployment claims are falling again after having bounced along for about a year. The absolute level is still comparable to the middle of the "jobless recovery" of the 2001 recession, but this time the recession itself was much, much worse. Relatively, the recovery is progressing, if too slowly.

Gross Domestic Product (GDP), the direct measure of the economy's size, is rising too, albeit too slowly. [(Read more.)]()

An aside to critics who think everything is worse since Obama took charge: Not true. New Claims and GDP have seen their slides ended, and are back up to well above the level of Inauguration Day.







Employment is the weakest part of the recovery so far. It's above the bottom, but weak. The next new data will be announced this Friday, Nov. 5. For several months, private-sector employment has been rising (good,) but cash-starved States and local governments are still having to lay off police, firemen, teachers, and more to meet their crisis budget limits. When local government layoffs taper off, that alone will mean rising overall employment and real progress for the country.

So, it's all disappointing but getting better slowly. How do we invest to deal with this?

The Fed's ultra-low short-term interest rates have been a disaster for people living off bank account interest or even 1- or 2-year CDs. They have gotten close to no income from those safe investments over the past year.

If you bought longer-term Treasury Bonds when I mentioned them favorably last March (bottom of page 5) , it's time to sell. You got about 15% capital gain in that half-year, plus the 4.6% coupon.

Definitely don't be greedy. I think bonds are about to enter a long decline. Not, as some fear, because of inflation, but because of recovery. When the recovery starts to get some traction, the Federal Reserve will have to start raising rates. They will want to signal that they won't let inflation get away, so the rise could be quicker than people expect, quicker than Greenspan would have done.

Rising rates mean falling bond prices. The capital gains of the past half-year will evaporate as rates move back toward their pre-crash levels.

I have a lot to say about why I don't expect inflation, but I'll save it for the next letter, which is already being prepared. For a review and preview, you can look at last January's letter, middle of page 3.

This year there's been a big run up in gold, to (non-inflation-adjusted) record levels. I believe the rise has been caused by

1. Some normal cyclical inflation-hedging,
2. Some End Of The World As We Know It (EOTWAWKI) hoarding
3. Momentum traders surfing this wave of buying.

What I said back in Sept. 2009 (top of p. 3) still stands. I have no interest whatsoever in investing in gold or silver, platinum, etc. The pro-gold voices are everywhere, though, so I'll bring in some real experts:

> Warren Buffet on Gold:
>
> "Look, you could take all the gold that's ever been mined, and it would fill a cube 67 feet in each direction. For what that's worth at current gold prices, you could buy all -- not some -- all of the farmland in the United States. Plus, you could buy 10 Exxon Mobils, plus have $1 trillion of walking-around money. Or you could have a big cube of metal. Which would you take? Which is going to produce more value?"[2]

2 Ben Stein, "Warren Buffett: Forget gold, buy stocks," Fortune, 19 Oct 2010, Cable News Network <http://money.cnn.com/2010/10/18/pf/investing/buffett_ben_stein.fortune/index.htm>. via John Nadler, "What's the Word?," Kitco.com, 20 Oct 2010 <www.kitco.com/ind/nadler/oct202010.html>.

as well as

> [O]ne need look no further than the latest take on all things macro by Jeremy Grantham; he, the CIO over at Boston-based firm GMO. In a "Night of The Living Fed" horror movie scenario, he notes that "global commodities, frightened by dollar weakness in response to QE2, have gone on a rampage, at least temporarily, with the entire CRB commodity index up 2.5% for the single day of Friday, October 8" [for example].
>
> Mr. Grantham also notes (while acknowledging that, yes, he too, owns some) that: "Everyone asks about gold. This is the irony: just as Jim Grant tells us (correctly) that we all have faith-based paper currencies backed by nothing, it is equally fair to say that gold is a faith-based metal. It pays no dividend, cannot be eaten, and is mostly used for nothing more useful than jewelry. I would say that anything of which 75% sits idly and expensively in bank vaults is, as a measure of value, only one step up from the Polynesian islands that attached value to certain well-known large rocks that were traded. But only one step up." Mr. Grantham feels that the Fed's asset bubble-blowing ways "and artificially stimulated asset prices encourages risk-taking investment behavior that can lead to asset bubbles that invariably end badly, as was the case with Internet stocks and housing."[3]

So what's left? For much the same reason that I last liked T-Bonds, now I like the stocks of big, strong companies with big, strong dividends. Unlike Treasuries, as the economy picks up the stock prices will grow, and eventually the dividends will rise as well. As downside protection, the dividend is there. Unless these companies fall on truly hard times, their dividends are pretty secure. Without further ado:

		10/25/10			(financial health checks)			
ticker	name	price	div	yield	PEG	trail P/E	payout	d/e
T	AT&T	28.36	1.68	5.94%	2.2	13.22	45%	67.93
EXC	Exelon	41.33	2.1	5.00%	11.33	10.81	55%	93.54
SNY	Sanofi-Aventis	34.84	1.63	4.71%	N/A	10.97	85%	18.25
MRK	Merck	37.42	1.52	4.10%	1.81	9.54	33%	32.56
PFE	Pfizer	17.62	0.7	4.00%	3.18	16.69	64%	50.07
KFT	Kraft	32.47	1.16	3.60%	1.91	11.83	43%	90.57
DD	DuPont	47.7	1.64	3.50%	1.63	13.91	48%	115.89
COP	ConocoPhillips	61.34	2.1	3.41%	0.59	9.73	34%	48.37
CVX	Chevron	84.87	2.88	3.40%	0.5	10.09	33%	10.2
JNJ	Johnson & Johnson	63.98	2.16	3.40%	2.14	13.22	42%	22.05
INTC	Intel	19.87	0.63	3.20%	0.81	10.69	33%	4.89

This selection is an ad hoc variation of the "Dogs of the Dow" (DotD) idea. DotD traditionally picks the 10 Dow Industrial stocks with the highest dividend yields. Investing in those 10 for a year has typically beaten the market by a healthy margin.

3 Jon Nadler , "Manipulation. Of Capitalism, that is," Kitco.com, 27 Oct 2010, <http://www.kitco.com/ind/nadler/oct272010.html>.

The basis for the concept is that stocks can be under-priced simply because they're boring or not fashionable. They get ignored, and the price drifts down to where the yield alone is reason to buy, and it will eventually catch the wandering attention of the analyst herd. Also, some stocks such as utilities have high yields because that's their only virtue: they're in businesses that are not expected to give them a chance to grow.

Be aware, though: some stocks have high dividends because they have problems. The extra dividend yield acts as a sweetener to compensate the investor for extra risk.

I have made an effort to pick stocks that don't have undue risks. Sometimes bad news comes like a lightning bolt, but I think these 11 are pretty safe. I've dropped some Dow stocks because of excessive problems, and picked up a few other stocks that are Dow-like but not among the chosen 30. The reason to pick ten or a dozen rather than cherry-pick a few is to diversify, effectively averaging away some of the unforeseeable risk. Before buying any, you should have your professional investment adviser do a sanity-check.

This is important.

It's **Credit Check** time again. With all the ID theft and fraud happening today, checking your Credit Report is a free way to assure that nothing is being done to you. Once per year per Credit Agency, you're allowed to get a free copy of your Credit Report, quickly, online. Do it now!

If you've been following along with my every-four-months pace, you're ready to revisit TransUnion. TransUnion.

I've taken notes from my own recent visit, so you can follow the instructions at www.longspliceinvest.com/CapDrain/TransUnion.pdf . This time I had no problems.

A closing thought:

> Mr. Grantham then sends one out of the ballpark with the observation that “Capitalism has been manipulated far more, and more dangerously, by the last two Republican-appointed Fed bosses than everything else added together,” Grantham added. “It is naive, if fashionable, to blame the rather current lame Administration for all of our problems. They inherited a cake already baked, or better, ‘half-baked,’ and the master bakers were the current and former Fed bosses.”[4]

It’s time to check the spelling and ship this to you.

4 ibid

If you have any questions, please write or phone. If you want to read more, the company web site has archived editions of this letter, lots of charts, and links to other interesting sites. There's also a web log where I discuss the process and progress of starting the mutual fund, along with occasional economic or investing thoughts..

Please forward this to any and all friends who are interested. Thanks! If you got this as a forwarded copy, you can get on the list to get your own future copies directly by sending me your email address.

Oh, and DON'T FORGET TO VOTE on Tuesday!

Take care,

Rick

Rick Drain
P.O. Box 5425
Redwood City CA 94063-0425
CapitalDrain@LongspliceInvest.com
www.LongspliceInvest.com

"Our doubts are traitors,
And make us lose the good that we oft might win,
By fearing to attempt."
--W. Shakespeare