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In one of our recent commentaries, we put out a general challenge to our readers to engage in some forward thinking. On the not-too-distant horizon, there are growing legions of aging Baby Boomers in North America, Western Europe and Japan that will cast sweeping shadows over economies, financial markets, healthcare infrastructures and political parties. In terms of our AARP framework, the time is approaching when we must *react* and determine how best to *accumulate*, *allocate* and *protect* assets when Baby Boomers on 3 continents are pushing through the retirement turnstyles.

But there is a more pressing need to *react*. Until very recently, the mainstream markets appeared to be in breakaway mode reminiscent of late 1990s, although the underlying reasons were anything but clear. Given relatively weak US economic fundamentals, we postulated that overabundant domestic credit and the booming economies of Asia had provided the impetus. Unfortunately, attractive double digit returns achieved by many investors in recent years have been misleading. When measured against a fairly steep rise in the cost of living for most Americans, the market gains have produced much less purchasing power than in years past.

In our quest to accumulate wealth and achieve meaningful lifestyle objectives, purchasing power is an extremely relevant concept. If prices of your favorite goods and services rise by 30% while your after-tax income and investment returns grow by 15%, either you must cut back on your consumption or dig into your principal, leaving less for your future living needs and/or wealth transfers to your heirs. This is America's new reality TV show and it isn't going off the air anytime soon.

Here are some tips for those who are ready to *react.*

WHAT'S IN YOUR WALLET? PART II

First and foremost, an important by-law of future investing will be to completely ignore what the government tells us about inflation. Despite Washington's claim that the national inflation rate is less than 4%, anyone with a checkbook knows that prices of essential goods and services are rising at near double digit rates. The reason is that money is being created at a faster clip than the demand for goods and services. Meanwhile, the government can manage its debt service and entitlement payments by capping the official inflation rate, commonly known as the CPI. Interest rates, Social Security and Medicare payments and government pensions are geared to the CPI. Consequently, a weak CPI means lower government borrowing costs and lower government payments to the elderly. Do not be deceived by the headlines. The CPI is rigged to greatly understate the true inflation rate.

Second, the term hyperinflation should scare you. It is what happens when "non-reserve" currencies are manufactured out of thin air when governments no longer are able to service their debts. Hyperinflation occurred in Germany during the 1920s, in Hungary during the 1950s and it is occurring today in Zimbabwe. Never before in modern history has the world's reserve currency been hyper-inflated. However, the supply of US Dollars is being expanded at double-digit rates and investors are starting to make adjustments. The fear is that the US Dollar will be demoted to a "non-reserve" or secondary currency in many parts of the world. The consequence is that Dollars would rapidly lose their purchasing power and the American standard of living would plunge. We are edging closer and closer to this scenario as our politicians continue to sanction massive spending deficits that require either tax increases or the bogus creation of money. Since tax increases do not play well at the polls, counterfeiting generally prevails…until it is exposed by those who stand to lose the most from the scam.

There is a new rule of thumb for investors that can be summed up in a simple equation. If the sum total of after-tax income and investment returns is not growing at near double digit rates, then purchasing power is being lost. The safe harbor portion of a portfolio generally yields 4-6%, as represented by low-risk money market funds, CDs and US Treasuries. This is looking more and more like a losing proposition. Either one must take a different tact and grab for higher returns or accept less purchasing power and possibly a declining standard of living. Do you remember the term “stagflation”? It was last in vogue during the Vietnam War era. Today “stagflation” is making a comeback in financial editorials. It signifies that growth in after-tax income and investment returns is not keeping up with cost of living increases.

Under our new investing rule of thumb, it is instructive to understand what’s in and what’s out. A capsule summary is presented below.

IN: Foreign currency-denominated fixed income investments. Besides the nominal interest rate paid on such investments, there is an extra kicker in the form of a currency that stands an excellent chance of appreciating against the US Dollar. In addition, the equity-indexed annuity is an intriguing investment vehicle that tracks popular market indexes while insuring against losses.

OUT: US Dollar-denominated fixed income investments yielding less than 6% per annum. This includes all US Treasuries, CDs, money market funds, traditional annuities and many corporate and municipal bonds.

IN: Stocks in companies that are capitalizing on growth in the new era Industrial Revolution countries, most notably Brazil, China, India, Russia and certain Middle Eastern oil exporting nations, and stocks in companies that control assets in relatively fixed or tight supply. This category includes agricultural products and natural resources that will be consumed (i.e., copper, corn, oil, soybeans, uranium, water) or held as a store of value (e.g., gold, silver.) The demand for agricultural products and natural resources will be fueled by the new era Industrial Revolutions occurring throughout Asia, Eastern Europe, India and Latin America. The challenge is that many of these companies are of non-US origin and can be difficult to analyze.

OUT: Stocks in companies that derive the bulk of their business from the US, Japan and Western Europe. The economic growth in these super-regions is slowly abating due to dependence on increasingly scarce and costly imported energy. In addition, aging populations can be expected to consume less as they conserve capital in expectation of longer life expectancies than were being assumed a generation ago.

IN: Investments that can be easily valued via arms-length transactions and are able to supplement paper returns with dividends or other cash returns. This will tend to favor the larger cap stocks (e.g., Dow Jones Industrials and S&P 500) over the smaller cap stocks (e.g., Nasdaq.) Exceptions within the smaller cap universe will tend to be resource-rich companies that have disproportionately high earnings and can afford to distribute cash.

OUT: Investments that cannot be easily valued (e.g., hedge funds, mortgage-backed bonds) or do not distribute cash. The most typical form of distribution is a dividend. Accounting tricks can produce earnings but not dividends. You can fake certain things in life but a dividend is not one of them.

In connection with the above, it is wise to remember the term “mark to market.” This term connotes the simple process of valuing an asset at the last known arms-length price. The entire derivatives world conveniently avoids “mark to market” or arms-length pricing. Instead, they use “mark to model” pricing, which are theoretical prices based on highly-subjective computer models. The recent Bear Stearns hedge fund blow-ups revealed the inherent flaws and deceptions of “mark to model” pricing. When Bear Stearns lenders organized an auction to liquidate mortgage-backed paper assets serving as loan collateral, the auction was unceremoniously scrapped when it was acknowledged that auctions set market prices.

Market intelligence suggested that an auction of these paper assets would bring 10-50 cents on the

dollar and that tens of trillions of Dollars worth of similar assets within the financial system would have to be revalued based on auction results. This would have been nothing short of a cataclysm. We would be staring into the abyss of the next Great Depression. Sadly, we are entrapped in a magnificent hall of financial circus mirrors. It is said that the very ratings agencies that we depend on for risk assessment are complicit in the deception and that $2 trillion of mortgage-backed investment securities has been given inflated ratings. Someone has been getting obscenely rich off this scheme and it has not been you. The bigger question is who will be left holding the bag. <u>As these types of investments implode, we should expect another avalanche of newly-created money in the form of government bail-outs, thus further cheapening the US Dollar and weakening its status as the world's reserve currency.</u>

It also is important to acquaint ourselves with the term "sovereign wealth fund." Countries that have accumulated large US Dollar surpluses are setting up investment funds to procure in clandestine fashion hundreds of billions of Dollars worth of strategic assets. In essence, increasingly wealthy countries are making a grab for (1) natural resources that will accommodate and perpetuate their economic growth well into the future and (2) tangible assets that will safeguard the purchasing power of their wealth. It also means that significant sums of money could wind up in the hands of harsh regimes that control resources deemed to have a strategic purpose. Examples are Iran, Venezuela and a host of African and Central Asian countries. Today, the largest sovereign wealth funds belong to Abu Dhabi, China, Singapore, Norway and Russia. The field is poised to expand in dramatic fashion as global competition intensifies for increasingly scarce assets.

These considerations underscore the need to assign portfolio weightings to agricultural products, natural resources and precious metals. These sectors represent assets that are in tight and/or relatively finite supply and are the antidotes to the overproduction of debt and undisciplined creation of money. In addition, they are recognized as such by the net savers of the world, which are now concentrated in Asia, Russia and the Middle Eastern energy-exporting countries.