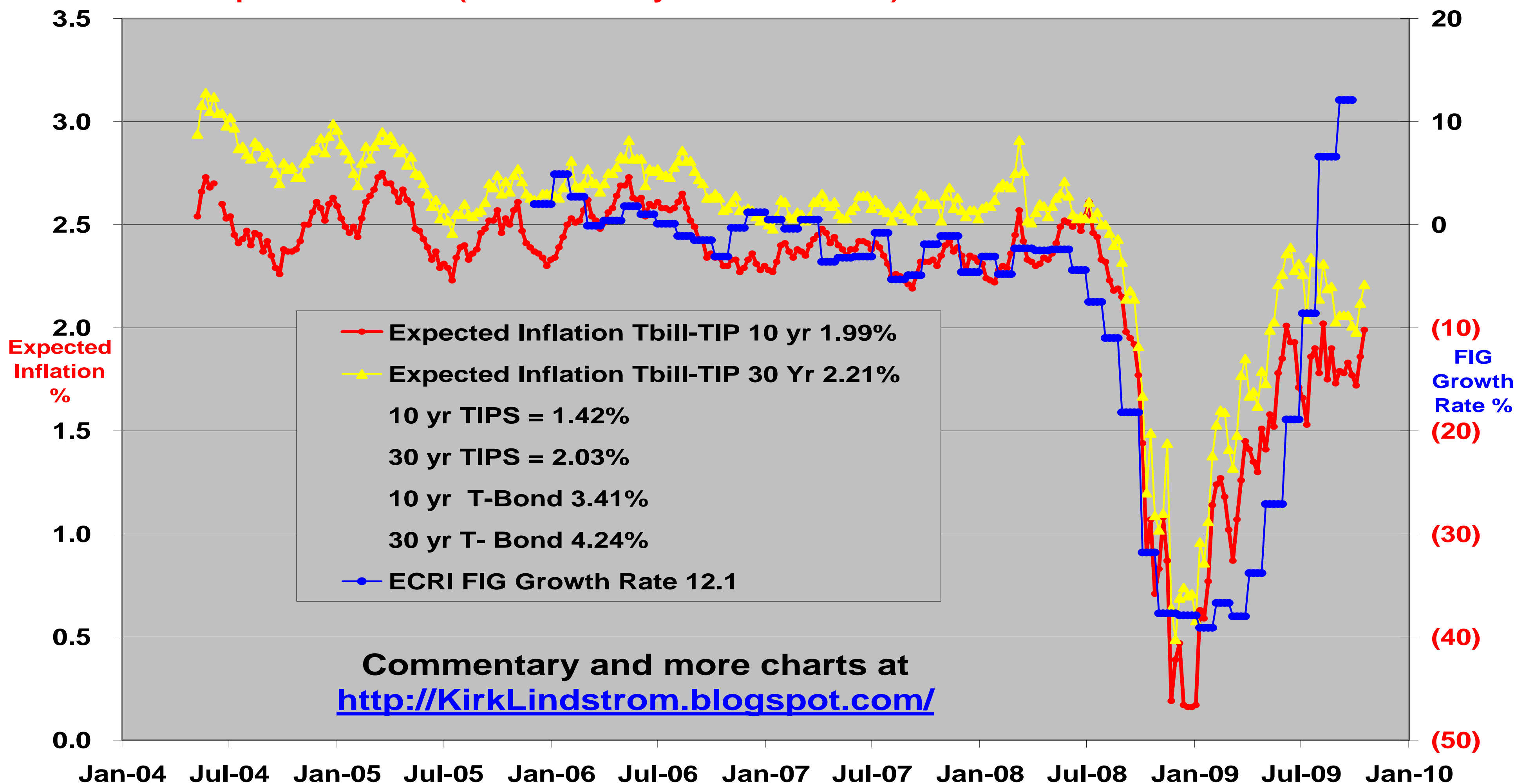
Kirk Lindstrom's November 2009 Investment Letter

Expected Inflation (10-Yr Treasury - 10-Yr TIP Rate) vs FIG Growth Rate 10/16/2009



This graph showing expected inflation vs. the growth rate of ECRI's FIG suggests that the 10 and 30-year US Treasury bonds pay too little in interest to compensate for future inflation. I believe rates are low artificially because the Federal Reserve has been buying Treasuries to keep rates low to help the economy. This should end as soon as it is clear the economy will recover which will put pressure on rates to go up. To get my recommendation for the fixed income part of your "core and explore" portfolio, you will have to subscribe to my newsletter[1]. Follow this link http://home.netcom.com/~kirklindstrom/Newsletter/Subscribe.html

Best CD Rates: http://verybestcdrates.com/index.html - **Composite Rates for iBonds**: http://tinyurl.com/iBondRates

[1] Since 12/31/98 "**Kirk's Newsletter Explore Portfolio**" is **UP 154%** (a double plus another **54%** !) vs. the **S&P500 UP at tiny 5.8%** vs. **NASDAQ down 0.9%** (All through 10/14/09)

As of October 14, 2009, "**Kirk's Newsletter Explore Portfolio**" is **up 30.7%** YTD vs. **DJIA up 14.1%** YTD

Blog: http://kirklindstrom.blogspot.com/

Effects of Inflation on Buying Power: How Inflation Erodes the Purchasing Power of $100

Annual Inflation Rate	2%	3%	4%
After 10 Years	$82	$74	$66
After 20 Years	$67	$54	$44
After 30 Years	$55	$40	$29

Modern Portfolio Theory (MPT) and Monte Carlo simulation indicates that a balanced portfolio with 50% in equities and 50% in US Treasuries should allow a 4% takeout a year for 30 years with a 98% chance of not outliving your money. A portfolio 100% in fixed income might be enough to live on today, but in 30 years of three percent inflation, it could have 40% of its buying power.

A 50:50 "balanced portfolio" should give you nearly all your retirement income from dividends and interest while net asset value gains of the stock market half, when rebalanced once a year, give you inflation protection.

For example, consider $100,000 today invested in GNMA funds paying about 5% a year. That gives you $5,000 a year to live on per $100,000 invested. If you need $50,000 a year to live on you would need $1,000,000 in GNMAs in today's dollars. In 30 years of 3% average inflation, that $50,000 could lose 60% of its buying power and leave you with the equivalent of only $20,000 in today's dollars!

I tend to like "120% in the market less your age" as a maximum allocation to equities. The equities are there for inflation protection so any money in TIPS or IBonds can further reduce this. For example, someone 70 years old could be 30% equities, 10% TIPS, 10% IBonds and 50% Total Bond (or GNMA) and have a wonderful portfolio as far as I am concerned. If you want to put 6% into my newsletter Explore Portfolio to try and increase your return, then you could be 28% equities (in my core index funds), 9% TIPS, 9% I Bonds, 48% Total Bond and 6% in my explore portfolio (which has some overlap in all the categories which is why I took a bit out of each.)

Long term, most but the biggest bears expect economies to grow so seldom is it wise to deviate from the above asset allocation. If you were able to accurately forecast a recession or depression well in advance, then moving some or all of a portfolio to fixed income ahead of time would make great sense, especially if you could get back into equities at a lower level.

The only reason I would deviate from your target asset allocation is if the Fed Model says the market is over valued as it did in 1999 and 2000. In 1998, my newsletter portfolio was 100% in equities. By January 2000 my portfolio was 17% in fixed income with 6% in a strip zero fund to give it "bond leverage." The strips did well and my overall portfolio only lost about 10% combined in 2000 and 2001, 12% better than the market. At the start of 2002 when the NASDAQ lost 38%, I had my portfolio about 30% fixed income and limited my losses to about what the S&P500 lost while the NASDAQ lost 38%. Then, as the market bottomed and valuations looked good, I added beta to my portfolio to get more bang for the buck. Since the end of 2002, I have greatly out performed the markets while only having 70% of my portfolio exposed to equities. Knowing what I learned from the last bear market, if I see over valuations again, I'll reduce my explore portfolio beta and increase my fixed income allocation even more, perhaps as much as ten or twenty percent. Academics call this "valuation based allocation" and is not considered market timing. Dr. Ed Yardeni uses the Fed Model to set his asset allocation as high as 90:10 in times of under valuation. At the top in 2000, he had his allocation at 30:70, recognizing valuation can catch up with stock prices so he always keeps some in the market.

More on Inflation: Inflation is not a problem as long as your income goes up to match it. If you retire and fund your retirement from the interest on CDs before you get 30 years of 3% inflation, then you might not have enough money because your principal doesn't go up with inflation thus you would lose 60% of your money's buying power.

Lets say you want to retire and have $100,000 a year in retirement income. Remember you will have no kids college to fund, your house may be paid off, etc. so $100,000 a year would be comfortable. How would you make sure you keep that $100,000 a year income adjusted for 3% per year inflation? What about 4 or 5% inflation? These are questions I have helped people answer for themselves using spreadsheets and articles about retirement portfolio management including safe withdrawal rates.

On Active Management, (explore portfolios or funds)

> *"Actively managed mutual funds? Yes. But only if they are run by managers who own their own firms, who follow distinctive philosophies, and who invest for the long term, without benchmark hugging. (Don't be disappointed if the managed fund loses to the index fund in at least one year of every three!)"*
> John C. Bogle in "The Little Book of Common Sense Investing", Chapter 18
> http://www.amazon.com/exec/obidos/ASIN/0470102101/kirklindstrom

On Market Timing

> *"The idea that a bell rings to signal when investors should get into or out of the stock market is simply not credible. After nearly fifty years in this business, I do not know of anybody who has done it successfully and consistently. I don't even know anybody who knows anybody who has done it successfully and consistently. Yet market timing appears to be increasingly embraced by mutual fund investors and the professional managers of fund portfolios alike."*
> John C. Bogle in "Common Sense on Mutual Funds", pg 20
> http://www.amazon.com/exec/obidos/ASIN/0471392286/kirklindstrom

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