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MOAR Return with Less Risk

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This is the seventh article that I have written for the *Gloom, Boom & Doom Report*, starting with "Beating the Dow with Bonds" on March 12, 1999, in which I pointed out how inexpensive long-term U.S. Treasury 0% Coupon Bonds (Zeros) yielding 5.83% to maturity were in relation to the S&P 500, then selling at a P/E of 34 and yielding 1.25%. From then until today, those Zeros have returned a cumulative 141.71% (see Figure 1) while the poor S&P has thrown off a measly 24.08%.

Two years later, I submitted "The Outlook for Bonds versus Stocks" in April of 2001, repeating the bonds vs. stocks argument at a time when long Treasury Zeros were yielding 6.19% while the S&P was selling at 25 times earnings and yielding around 1.3%. Since then, those Zeros have appreciated by 133.9% while the S&P has given investors a cumulative total return of 26.06% over the same 10 years.

On February 28, 2003, I wrote "Beating the Dow with Gold", recommending gold, then selling at US\$349.95/oz, based on its very depressed price (1/23 of the DJIA vs. a 1/10 historical median [see Figure 2]), the likelihood that the U.S. Federal Reserve would continue its deflation-fighting policy, and the fact that, in spite of the S&P being near the end of a two-year bear market, stocks at 28 times trailing earnings and paying dividends averaging 1.8% were still extremely

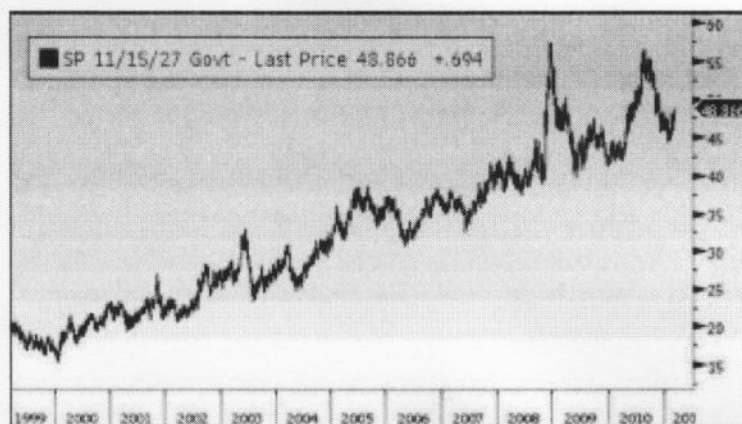
overvalued. As of tonight's close, gold has risen by 307.6% (see Figure 3) or 3.8 times the S&P's cumulative return of 80.9%. In addition, while the S&P has swung wildly from years like 2003, when it rose 26.38%, to 2008, when it crashed down 38.49%, gold has not had a single losing year.

Later, in January of 2005, I wrote "Beating the Dow with Dogs" recommending the Dogs of the Dow strategy which I devised and wrote a book about (*Beating The Dow*, HarperCollins, 1991) in 1990. The strategy involves picking the most undervalued Dow Jones Industrial Average components on the basis of their dividends and low dollar price.

Those recommendations fared slightly worse than the S&P, returning a mere 2.85% annually versus 3.65% per year for the index.

The recommendations made in my January 1, 2008 article entitled "Beating the Dow with Value" fared even worse than 2005's. In that article, I suggested diversifying equally across what I considered to be four attractive areas: the Dogs of the Dow in the U.S., the Dogs of the World (the five cheapest countries in the world), Energy Producers, and Precious Metals Miners. In the little over three years since, those recommendations have declined at a compound annual rate of 6.3%

Figure 1 U.S. Treasury STRIP Due 11/15/27



Source: Bloomberg

Figure 2 DJIA/Gold Ratio, 11/30/28 to 3/17/11



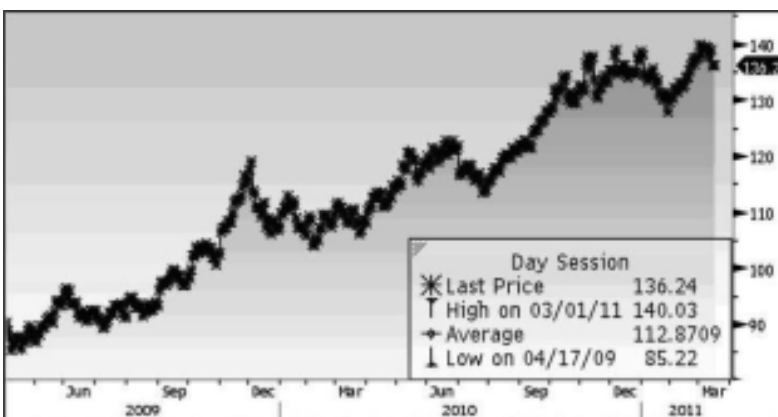
Source: Bloomberg

Figure 3 Gold Price, 1999–2011



Source: Bloomberg

Figure 4 SPDR Gold Trust (GLD), 2009–2011



Source: Bloomberg

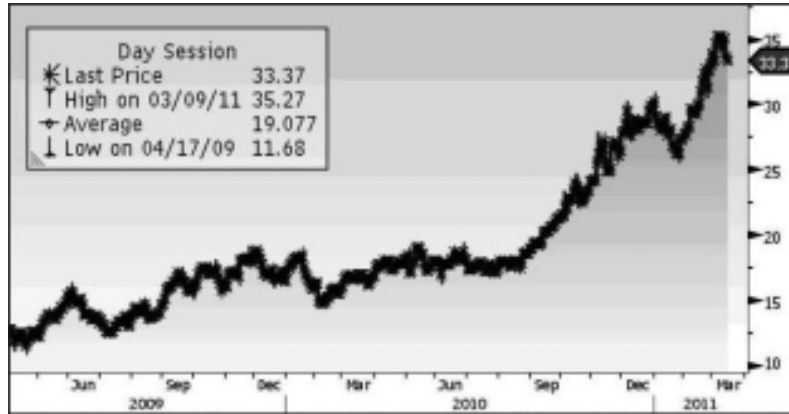
compared to the 1.6% annual rate of loss of the Standard & Poor's 500.

Most recently, in "Confessions of a Value/Contrarian Investor" in April of 2009, written shortly after the March 2009 bottom, I suggested that, given the U.S. Government and Central Bank's reflationary efforts, a portfolio divided among precious metals, gold and silver miners, and Treasury Inflation Protected Notes (TIPS) should perform well. That portfolio, with 12.5% invested in the SPDR Gold Trust (GLD), 12.5% in the iShares Silver Trust (SLV), 25% in the Market Vectors Gold Miners ETF (GDX), and 50% in the iShares Barclay U.S. Treasury Inflation Protected Securities Fund (TIP), would have, over the last two years, returned a cumulative 58.52% (see Figures 4, 5, 6, and 7), easily beating the MSCI World Index's 53.32%, and even the S&P's 61.6% on a risk-adjusted basis since only half of the money was really at risk.

So, readers who followed the recommendations of the first three and last articles and held them until now enjoyed outstanding returns in both relative and absolute terms, while the recommendations of the two middle pieces slightly underperformed. In this business, four out of six ain't bad. One would think that someone who had demonstrated such foresight in the past might be facing the future with a high level of confidence but, for the first time in decades, I seriously doubt my ability to foresee how things are going to play out in the coming years.

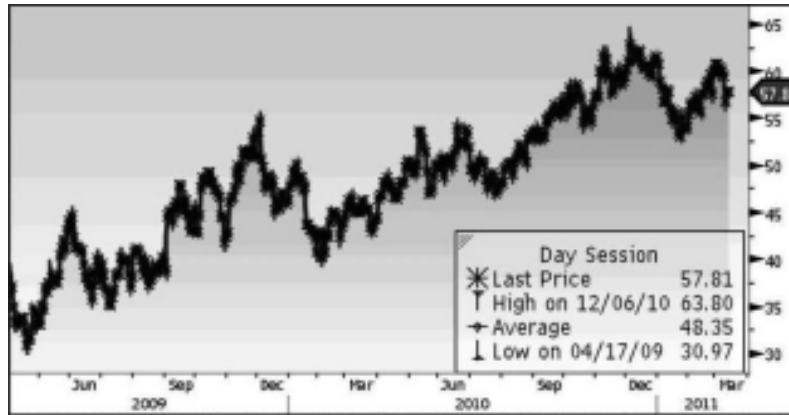
The powers that be worldwide have embarked on a path that seems likely to result in a revival of high rates of inflation or even hyperinflation. On the other hand, there are many reasons to believe that they may not be successful in their quest because of the huge amount of debt that has been created both privately and governmentally, not to mention the unfunded liabilities that promised future benefits have created. If that huge mountain of debt — I've seen estimates as high as US\$650 trillion — shrinks at a faster rate than the central banks are able to print, a debt

Figure 5 **iShares Silver Trust (SLV), 2009–2011**



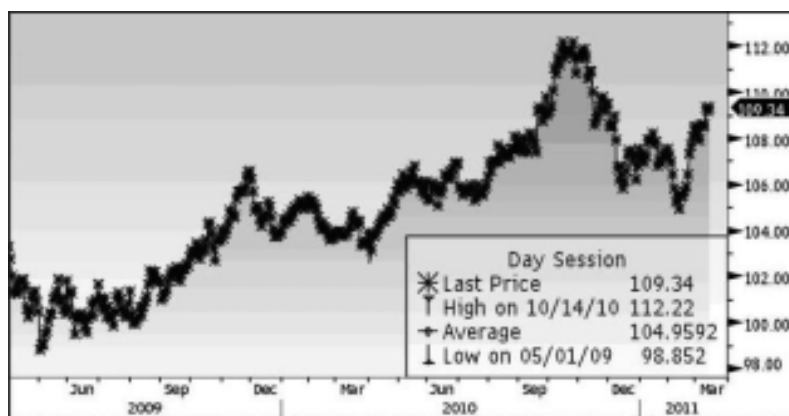
Source: Bloomberg

Figure 6 **Market Vectors Gold Miners (GDX), 2009–2011**



Source: Bloomberg

Figure 7 **iShares Barclays TIPS Bond (TIP), 2009–2011**



Source: Bloomberg

deflation could well occur. In addition to the uncertainty over whether we are going to have inflation or deflation going forward, there is the problem of valuation in most of the investable assets around the world.

The S&P 500 has risen 98.5% from its March 2009 lows, just under the median of 99.9% for 14 Bull Markets that have occurred since 1929 (see Figure 8), the S&P's 15 P/E is at the historical median level (see Figure 9) and its 1.9% dividend yield is at the low end of its historical range (see Figure 10). So, stocks are not especially cheap. Gold is up 474% from its July 1999 lows (see Figure 3) and, at 1/8 of the Dow Jones Industrial Average (DJIA) (see Figure 2), is well above its long-term average ratio of 1/10 the DJIA. Long-term Treasuries at 4.44% are near the low end of their range going back to the 1920s (see Figure 11) and are yielding only 201 basis points (bps) above the 9-year moving average of the Consumer Price Index (CPI) when the long-term average spread has been 274 bps. And let's not even talk about U.S. Treasury Bills yielding 0.10% or 140 basis points LESS than last year's inflation rate and 290 bps LESS than the long-term average of CPI when, historically, T-Bills have paid investors approximately 70 bps ABOVE the CPI.

Furthermore, my guess is that we are about 2/3 of the way through another several decade sideways period for stocks similar to what happened from 1929 to 1954 and 1965 to 1982 after stocks became grossly overvalued (see Figure 12). In fact, if one uses an inflation-adjusted S&P (see Figure 13), the sideways periods have been even longer. The demographic effect of 1/3 of the U.S. population, the Baby Boomers born in the decade after World War II, moving into their naturally risk-averse retirement years, and the need to deleverage and rebuild their savings by the rest of the citizenry, should reinforce the declining trend in stocks that has been in effect since early 2001.

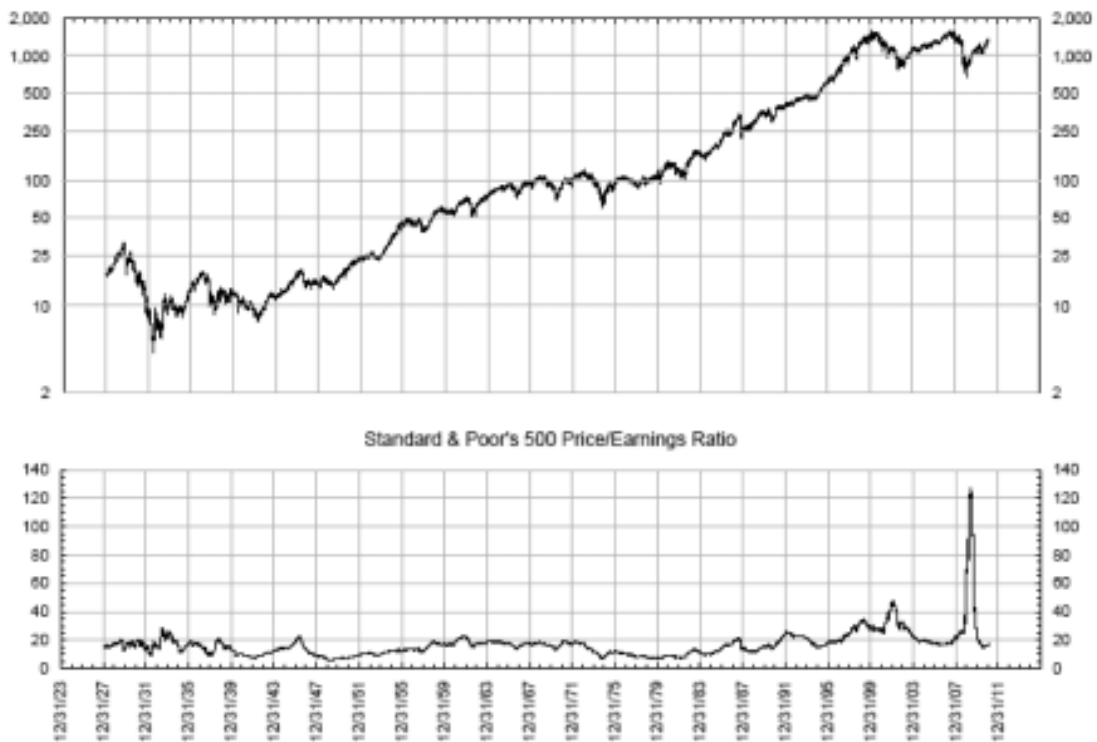
Therefore, I would like to discuss the advisability of admitting that

Figure 8 Major Market Declines and Advances, 9/16/1929 – 2/18/2011

High Date	Low Date	Bear Months	S&P 500 Index		Bear Market % Change	Subs Bull	Bull Years
			Closing High	Closing Low			
09/16/29	06/01/32	32.1	31.86	4.40	-86.20%	324.30%	4.8
03/10/37	03/31/38	12.5	18.67	8.50	-54.50%	62.20%	0.6
11/09/38	04/28/42	41.1	13.79	7.47	-45.80%	157.70%	4.1
05/29/46	05/19/47	11.5	19.25	13.77	-28.50%	23.90%	1.1
06/15/48	06/13/49	11.8	17.06	13.55	-20.60%	267.10%	7.0
08/02/56	10/22/57	14.5	49.74	38.98	-21.60%	86.40%	4.2
12/12/61	06/26/62	6.4	72.64	52.32	-28.00%	79.70%	3.6
02/09/66	10/07/66	7.8	94.06	73.20	-22.20%	48.10%	2.1
11/29/68	05/26/70	17.7	108.37	69.29	-36.10%	73.50%	2.6
01/11/73	10/03/74	20.4	120.24	62.28	-48.20%	125.60%	6.2
11/28/80	08/12/82	20.2	140.52	102.42	-27.10%	228.80%	5.0
08/25/87	10/19/87	1.8	336.77	224.84	-33.20%	579.40%	12.4
03/24/00	10/09/02	30.1	1,527.46	776.76	-49.20%	101.20%	5.0
10/09/07	03/09/09	16.8	1,565.15	676.53	-56.78%	98.51%	2.0
Median		15.6			-34.65%	99.86%	4.2

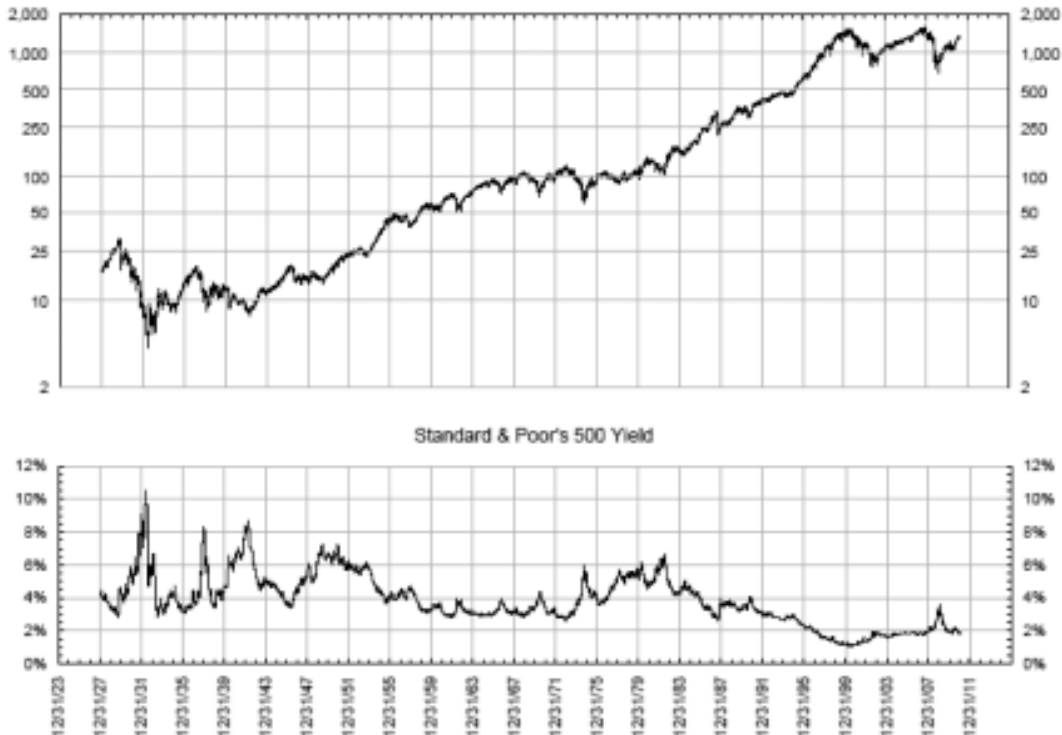
Source: Bloomberg

Figure 9 S&P 500, 1927–2011



Source: Ron Griess, www.thechartstore.com

Figure 10 **S&P 500, 1927-2011**



Source: Ron Griess, www.thechartstore.com

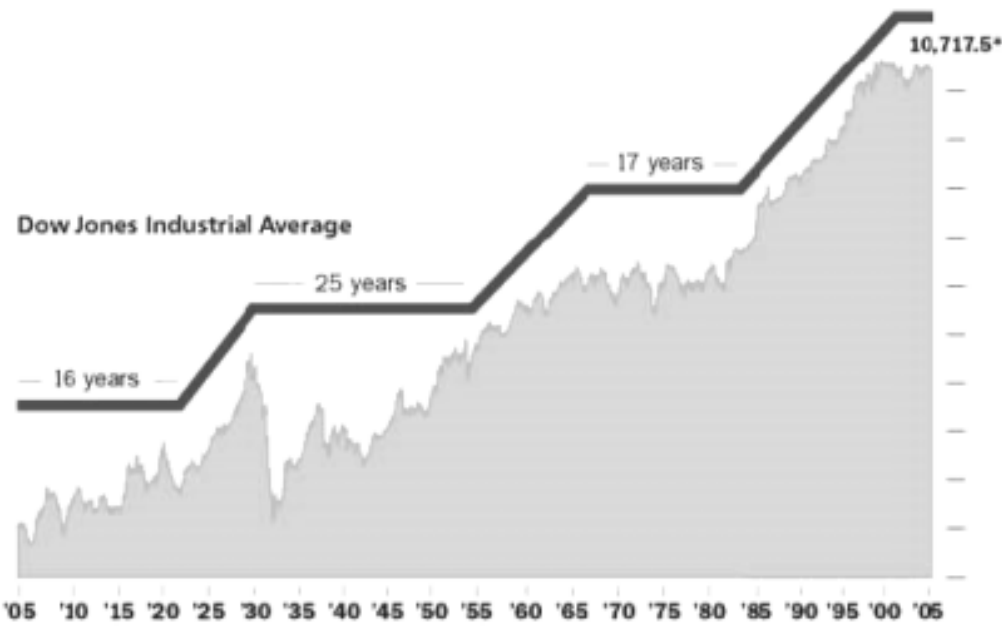
Figure 11 **US Treasury Weekly Average Yields (Long-Term Constant Maturity), 1941-2011**



Source: Ron Griess, www.thechartstore.com

Figure 12 **A Century of Starts, and Fits**

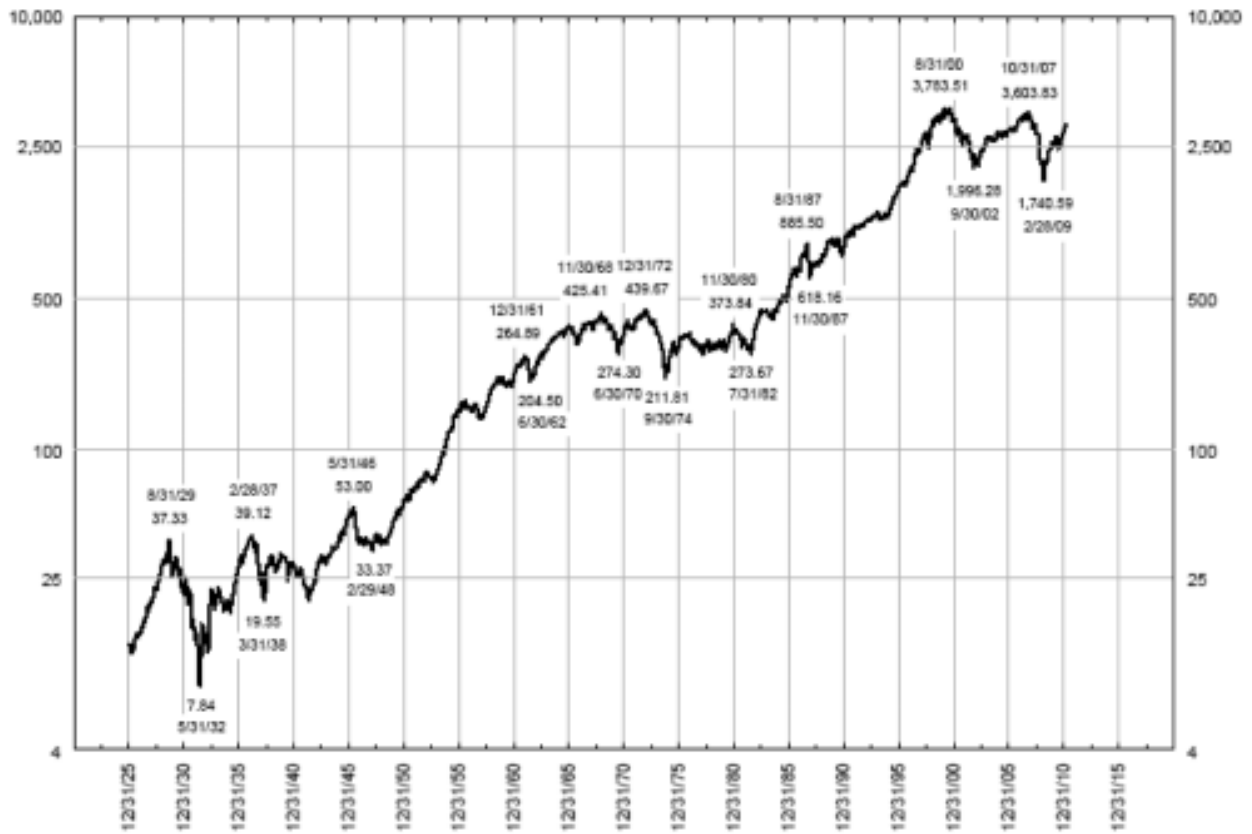
Long periods of sideways movement in the Dow have tended to follow secular bull markets.



* As of December 31, 2005

Source: Rydex Investments

Figure 13 **S&P 500, Inflation-Adjusted Total Return Index, 1925–2011**

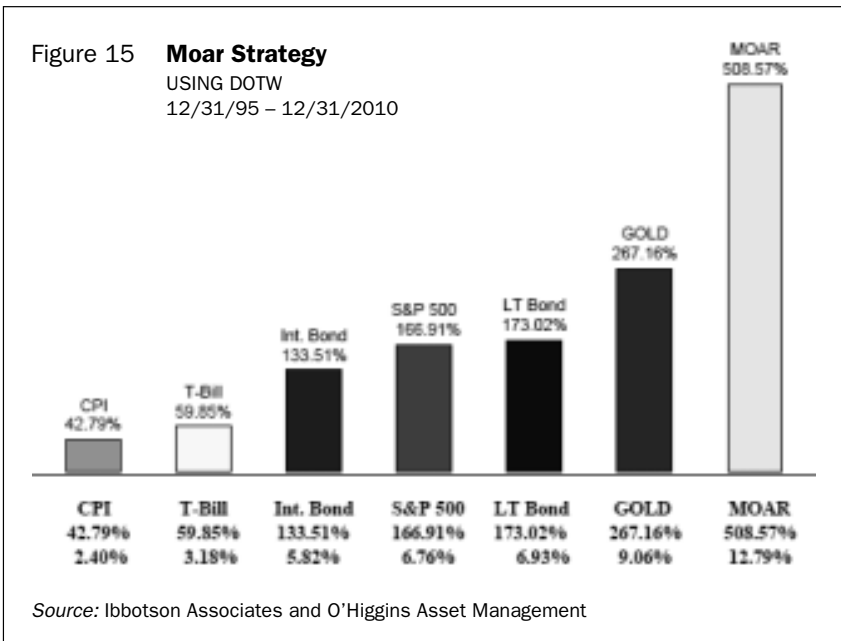
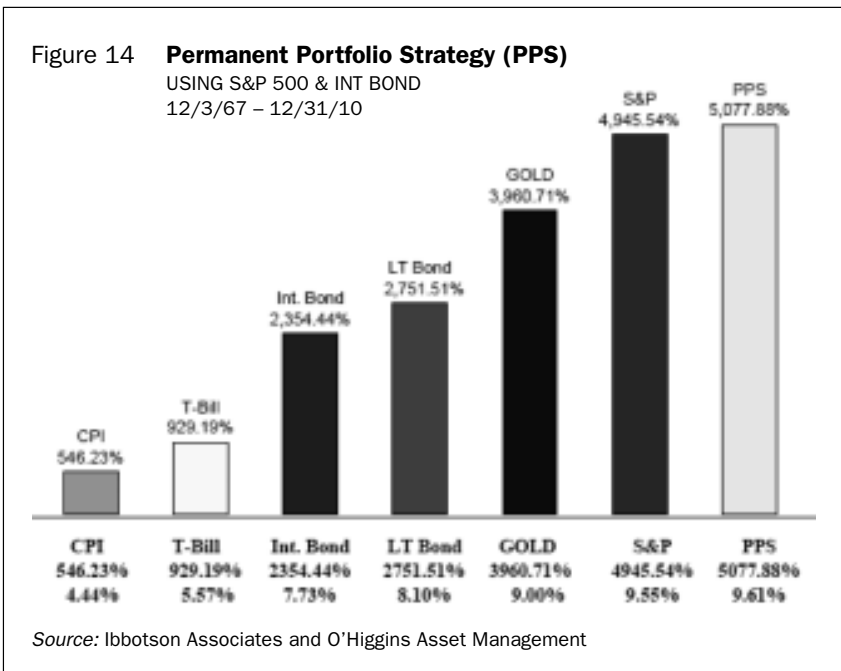


Source: Ron Griess, www.thechartstore.com

none of us, including me, really knows what the future holds, and pursuing a variation of a strategy first advocated by Harry Browne in his 1998 book, *Fail Safe Investing*. In his book, Browne advocated what he called “The Permanent Portfolio”. Simply explained, the strategy involves investing equally in U.S. stocks, gold, long-term U.S. Treasury Bonds, and short-term U.S. Treasury Bills with regular re-balancing. However, because of their relatively low volatility and the substantially higher returns that they have produced over the years, I substituted Intermediate Bonds for Treasury Bills in my back testing of Browne’s strategy.

When I back tested my variation of The Permanent Portfolio strategy back to 1967 — Gold started to trade above the U.S. Government’s US\$35 fixed price in 1968 — I found that it would have matched the performance of the S&P 500 but beaten Gold, Bonds and inflation by substantial margins (see Figure 14) but it would have done so with only 3 losing years compared with Gold’s 17, Long Term Bonds’ 12, the S&P’s 10, and Intermediate Bonds’ 4 negative years. Furthermore, the worst loss would have been a drawdown of 7.18% in 1969 while the S&P lost more than 37% in 1973–1974, 2000–2003, and 2008. Interestingly, my version of Browne’s strategy would have produced profits of 29.9% in 1973–1974, 14.2% in 2000–2003, and 1.74% in 2008. This combination of a low level of volatility and modest returns makes it much less likely that investors would be scared into bailing out at a market bottom and staying in cash during the most profitable part of the subsequent bull market. Studies have shown that the tendency of investors to do just that is the main reason most equity mutual fund investors fail to reap the rewards of equity investment.

My variation on Harry Browne’s theme, which I call the MOAR Strategy (Michael O’Higgins Absolute Return), involves several major differences with Browne’s Permanent Portfolio. First, instead of using only U.S. stocks, I use the five



most undervalued investable stock markets in the world, which I call the Dogs of the World (DOTW). In addition, instead of Cash, I use U.S. Intermediate Term Treasury Notes. Lastly, in each year following a losing year for the DOTW, I take five percentage points from each of the other categories and use it to overweight the DOTW, thereby capitalizing on the historical tendency of equities to outperform other investments in years following

stock market declines. The equity weighting is then brought back to normal, in 15 percentage point increments, as stocks rebound in the ensuing years.

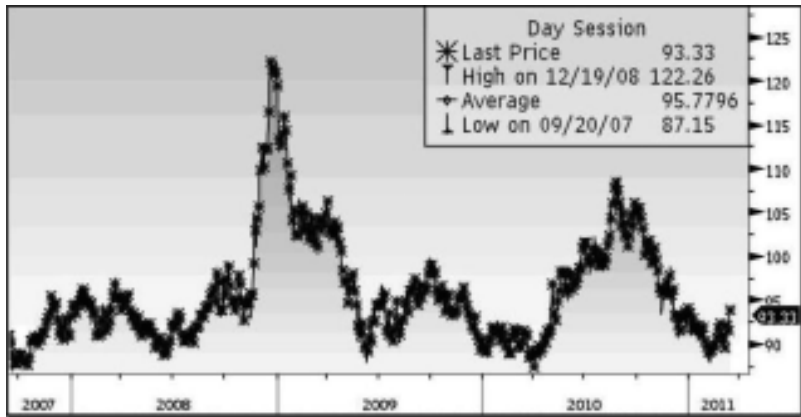
Beginning in 1996 — because I only have DOTW performance figures since 1995 — the MOAR Strategy would have significantly outperformed every major stock index, long- and intermediate-term bonds, gold, cash, and inflation (see Figure 15), and done so while

suffering only 1 losing year when every other investment, with the exception of cash, had anywhere from 2 (Intermediate Bonds) to 5 years (Gold) of declines. That is what I mean by MOAR Return with Less Risk.

So, given the foregoing, how would I structure a portfolio that would likely provide an attractive, relatively steady, real inflation-adjusted return in the scary, probably sideways, market years that lie ahead? I would put 25% in the iShares Barclays 20+ Year Bond Fund ETF (TLT), 25% in the iShares Barclays 7–10 Year Bond Fund ETF (IEF), 25% in the SPDR Gold Trust (GLD), and 5% each in the iShares MSCI Belgium Index Fund (EWK), iShares MSCI France Index Fund (EWQ), iShares MSCI Italy Index Fund (EWI), iShares MSCI Ireland Index Fund (EIRL), and the iShares MSCI Spain Index Fund (EWP) (see Figures 4, 16, 17, 18, 19, 20, 21, and 22).

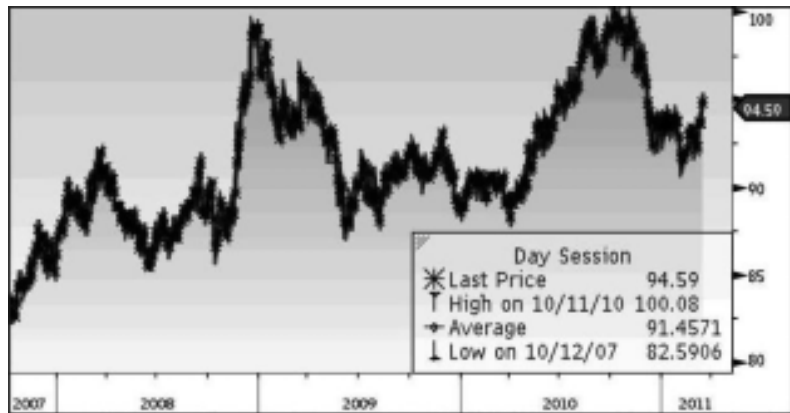
Time will tell, but I think that this will be a good way to survive and prosper in what I think is likely to be a turbulent period ahead.

Figure 16 iShares Barclays 20+ Year Bond Fund (TLT), 2007–2011



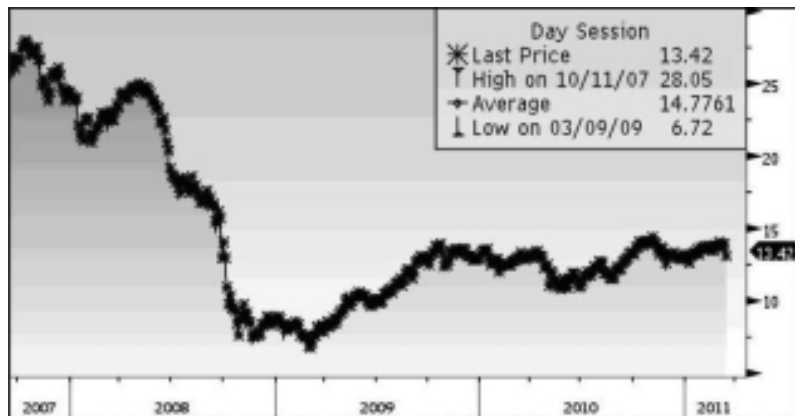
Source: Bloomberg

Figure 17 iShares Barclays 7–10 Year Bond Fund (IEF), 2007–2011



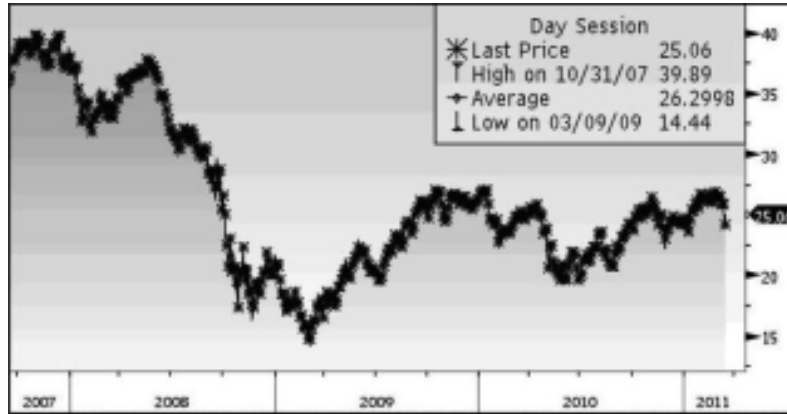
Source: Bloomberg

Figure 18 iShares MSCI Belgium Index Fund (EWK), 2007–2011



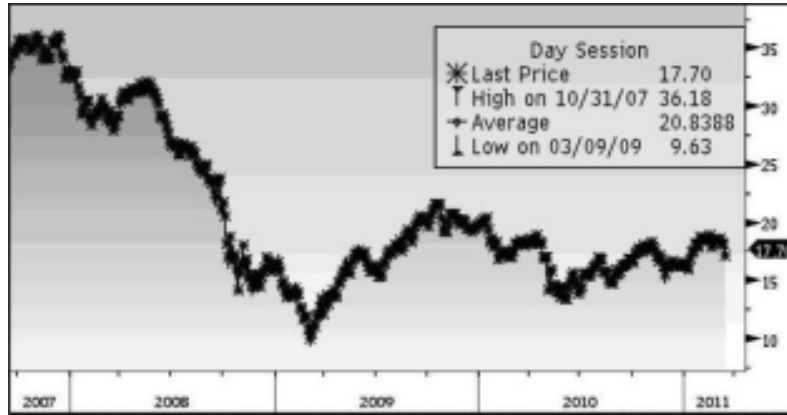
Source: Bloomberg

Figure 19 iShares MSCI France Index Fund (EWQ), 2007–2011



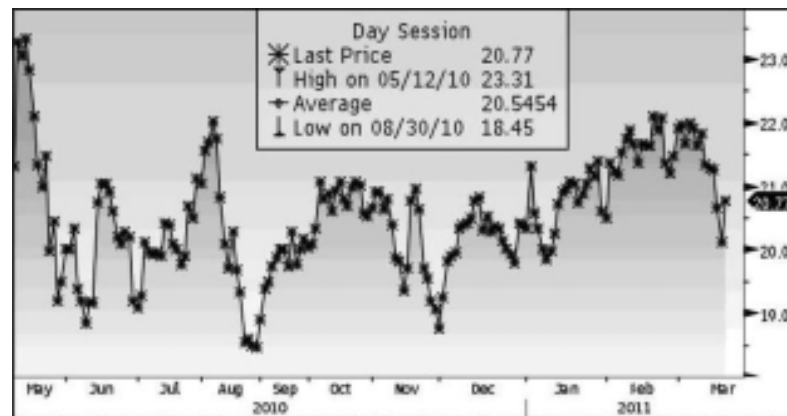
Source: Bloomberg

Figure 20 iShares MSCI Italy Index Fund (EWI), 2007–2011



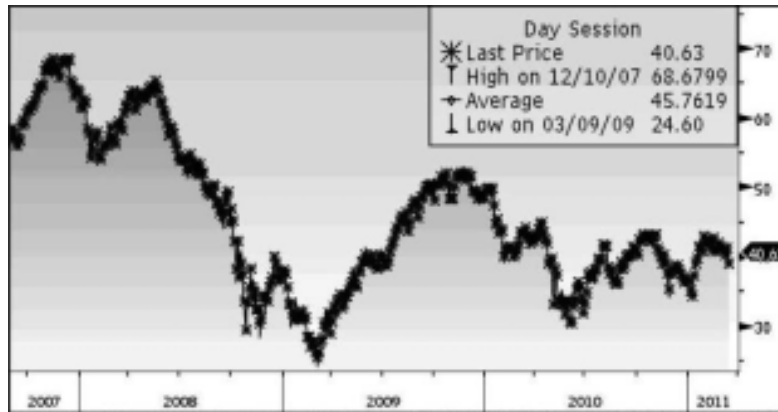
Source: Bloomberg

Figure 21 iShares MSCI Ireland Index Fund (EIRL), 2010–2011



Source: Bloomberg

Figure 22 iShares MSCI Spain Index Fund (EWP), 2007–2011



Source: Bloomberg

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