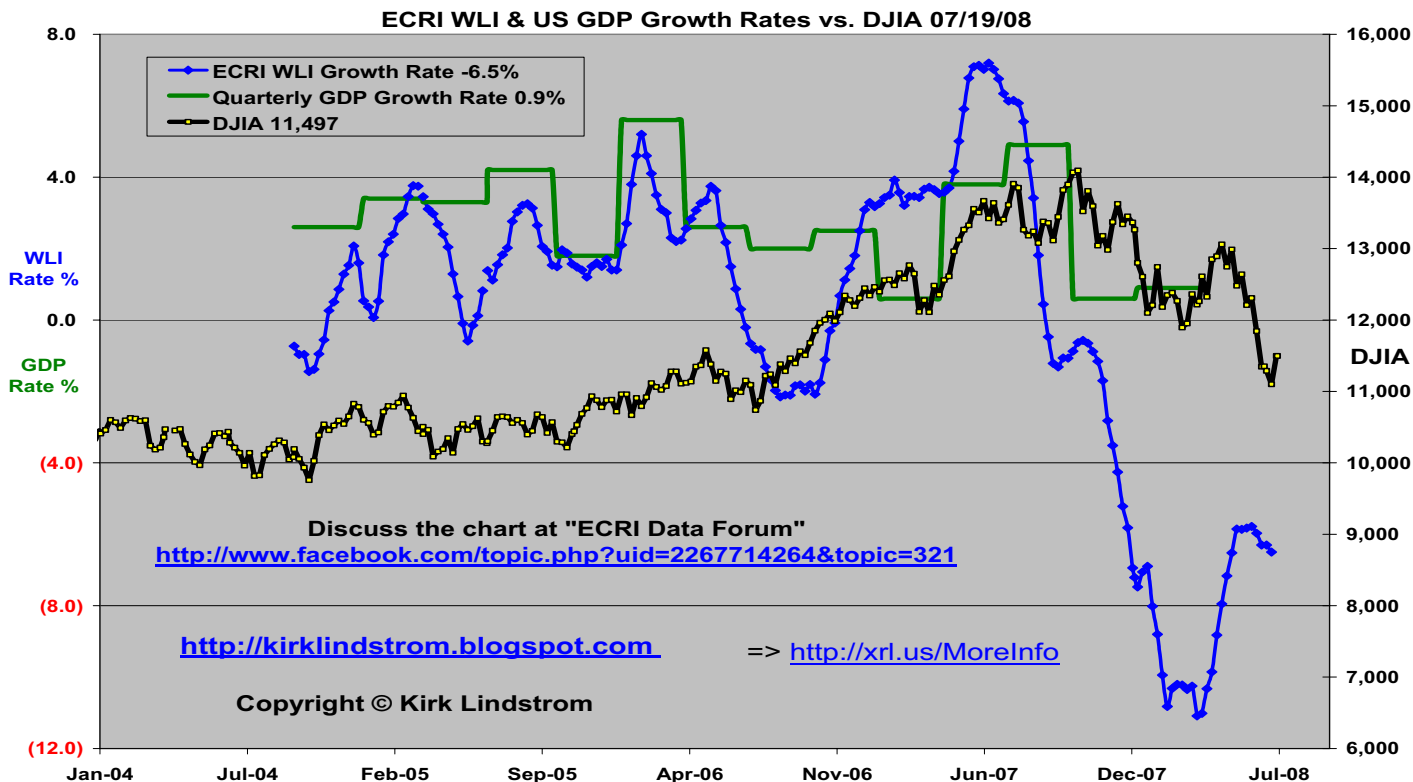


Kirk Lindstrom's August 2008 Investment Newsletter

7/19/08: ECRI's⁴ Weekly Leading Index (WLI) update: (From <http://www.businesscycle.com> with permission)

ECRI said, "The slide in the already negative WLI growth to an eight-week low affirms its recessionary standing."



7/19/08: ECRI's U.S. Future Inflation Gauge (FIG) Update: (From July 3, 2008 Press Release)

- "Despite higher oil prices and the weaker dollar, the USFIG continues to slide as underlying inflation pressures in the U.S. remain in a cyclical downtrend," said Lakshman Achuthan, managing director at ECRI.
- This report shows that inflation is expected to be lower even though current inflation above 5% is over double the 2% readings from not long ago.

Inflation: The Consumer Price Index (CPI) for All Urban Consumers (CPI-U) increased 1.1% in June, before seasonal adjustment. The index is 5.0% higher than in June 2007. Core CPI that strips out volatile food and energy was up 2.4% over June 2007. CPI was pushed higher by a 6.6% jump in energy prices and 0.8% gain in food prices. Federal Reserve Chairman Ben Bernanke said Wednesday July 16 in testimony before congress "Inflation currently is too high."

August Meeting Outcomes

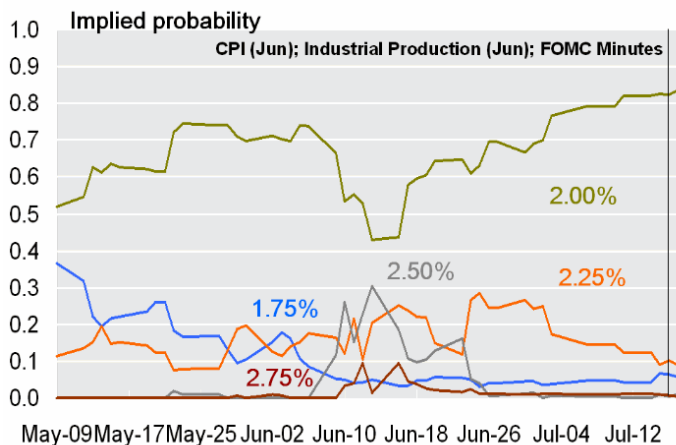


Chart courtesy of Federal Reserve Bank of Cleveland

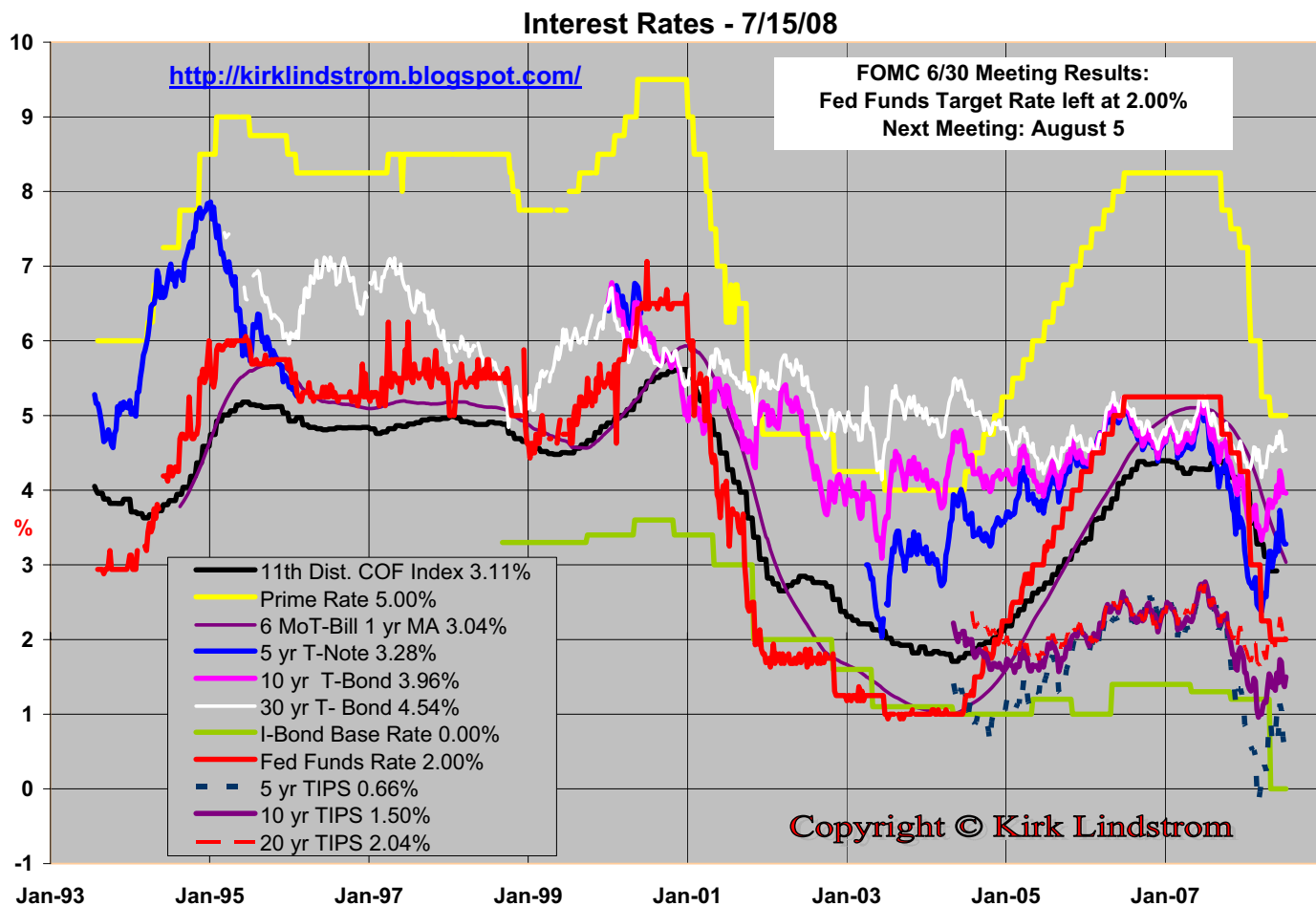
The Federal Reserve open market committee (FOMC) on June 24 and 25 kept the Fed Funds Target Rate at 2.00%. One member voted to raise rates. The FOMC next meets on August 5. The odds are over 80% that they will leave rates at 2.00%. Of more interest is the odds favor rates will go up next rather than down. This should be good news for the US dollar.

ECRI's FIG may be telling us we will not see run-a-way inflation, but it does not mean we will drop back to low inflation either. June's 1.1% CPI gain was the biggest jump in 26 years! To make matters worse, the core rate of inflation, which strips out volatile food and energy, at 2.4% is still well above the Fed's 1.0 to 2.0% comfort zone.

High inflation and low economic growth is called "stagflation" which is not good for the stock markets. Let us hope ECRI's FIG and the FOMC's belief are correct that inflation will come down. The sharp decline in oil prices this week may have been the start towards lower inflation.

⁴ ECRI stands for Economic Cycle Research Institute. Ask them questions here <http://investment.suite101.com/discussion.cfm/18>

7/15/08: Interest Rate Update:



Fixed Income - Core Portfolios: Long-term interest rates are just as hard to predict as the stock market. Now and then, you might get a fat pitch, but over the long haul, diversification usually works the best for both stocks and fixed income. One way to remain diversified is with a total bond fund that I use in my simple core portfolios (to keep reporting returns easier.) A better method is to have roughly one third of your fixed income in each of these categories for “triple diversification” using the “3-bucket approach” below:

- Bucket #1: Total Bond and or GNMA funds for deflation protection and income
- Bucket #2: CASH, CD ladders, treasury ladders, money funds and short term but high quality bond funds for income
- Bucket #3: I Bonds and TIP funds for inflation protection and income

You do not need to have a third in each for this to work. You could put 60% in the center “bucket” and 20% in the other 2 buckets if you are not comfortable with bond funds that fluctuate in net asset value. The idea is to have a set percentage for each so when one bucket out performs the others you take profits to rebalance.

7/15/08: New **I Bonds** currently pay 4.84% for 6 months after purchase with a base rate of 0.00%. (yes zero!) This rate is good until October 31, 2008. I do not like I-Bonds for purchase with the 0.00% base rate. Series EE bonds are even worse with a 1.4% total rate effective through October 31, 2008. For inflation protection in bonds, TIPS are currently your best choice with real (base) rates between 0.66% for 5-year and 2.04% for 20-year TIPS. (Tips pay the base rate plus inflation.)

Vanguard Fund (7/15/08)	SYMBOL	Yield	YTD
GNMA	VFIIX	5.07%	2.12%
Total Bond Index	VBMFX	4.70%	1.57%
Prime Money Market Fund	VMMXX	2.21%	1.65%
Total Stock Market Index Fund (for comparison)	VTSMX	1.99%	-15.42%

Best CD Rates: <http://forbestadvice.com/Money/HighestCDRates/index.html> Updated monthly or more often.

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 GNMA's 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% IBonds, 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/kirkindstrom>

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/kirkindstrom>

Kirk Lindstrom's August 2008 Investment Newsletter

FAQs (Frequently Asked Questions): (Updated **5/14/08**)

Auto Buys and Sells are "limit orders" you place at your broker ahead of time that buy or sell when the specified price is reached. See your broker for details and instructions on how to enter the orders. A "**stop loss**" is a sell limit order that triggers when a price falls to the specified amount while an "auto buy" is a buy limit order that triggers when the price falls to the specified amount. I usually use "Auto Sell" orders to take profits after a stock I bought has made big gains and at a natural price resistance level.

How much to invest? I recommend my explore portfolio for 5 to 20 percent of your investment portfolio and the rest should be in one of my core portfolios or something similar. **Do not make the mistake that some have by avoiding my best gainers because they are up the most. Often the best gainers continue to outperform. To get my returns going forward, you have to duplicate my portfolio.** This gets easier the longer you follow me. I like what I hold and could go to 100% cash at zero tax cost (newsletter portfolios are not real so they don't pay taxes.) The fact I hold a security in the portfolio says I like it for the long term.

I buy good companies for the long term, take profits when they are up and wait for pullbacks to buy again. Every new subscriber has to decide if you want to duplicate the portfolio or just follow selected parts. Those that decided to follow my ideas when the market was bottoming in the Fall of 2002 and I was buying, or any of the other periods of weakness where I bought back profit taking shares, have huge gains and big smiles. I took plenty of profits near the May 2006 top and bought back and added shares on the summer decline, hopefully to ride to new all time portfolio highs.

It may look like I am saying "sell" but you have to look at asset allocation. Unless I am selling all my shares, I am usually simply pulling out some profits to keep my allocation to that security where I want it. Pay attention to the overall portfolio and what I am doing there such as taking profits in the areas I've had great gains.

Core Portfolio Asset Allocation 5/21/08: As long as expectations for future economic growth are positive and the expected future earnings justify the market valuation based on PEG¹¹ and earnings yield from "the Fed Model" then the following asset allocations make sense:

- Conservative¹² investors: 50% in the stock market and 50% in fixed income.
- Aggressive investors: 80% in equities and 20% in fixed income.

The above is only a suggestion. I like my rule-of-thumb that has your allocation to equities at 120 less your age less the percentage of your fixed income in inflation-protected securities (IBonds & TIPS). Reason: For the past 50 years, stocks have on average had a "real earnings yield" of 2.47%. If you can get TIPS or IBonds with the base rate at or above this 2.47%, then those TIPS and IBonds should be a good substitute for equities as inflation protection.

Some people are so adverse to risk that they have all their money in fixed income securities. What they lack is inflation protection that comes from the higher average returns of the stock market.

Dynamic rebalancing, what I do with the explore portfolio and my personal money, means you set a level above or below the targets that you automatically take profits to rebalance back to the target allocation. This is more work but it can pay extra returns.

Refund Policy: I charge \$25 per current issue sent so your max risk is \$25 for the first month. If you cancel, then I deduct \$25 per issue sent from what you paid. This way, after six months, the next six months are free (and any free back issues you request are free.)

When to buy or sell: New subscribers often ask me if I will give them a clear signal about when they should move from the cash positions they are in to my recommended core portfolios. I DO NOT advise market timing your core portfolio, period! Since I am not an investment advisor and do not give individual advice, I tell them what I would do if it were my money. I would either:

- Lump sum in now: Because the markets have a 200+ year history of going up, the odds favor sooner rather than later for getting into the market.
- or
- Dollar cost average in equal portions every month into the core funds over a period of a year or two. Lets say you have \$240,000 in cash that you want to put into the market over a two year period. I'd put \$10,000 a month into the funds in my core portfolios at a ratio that is close to what I recommend but meets the minimum requirements for the funds. If the market corrects 5%, double up and put in \$20,000 and \$30,000 if it goes down 10%. That is take advantage of market weakness to accelerate your dollar cost average program. With any luck, you will get a correction and get extra return. If the market continues to go up, you are at least participating. If you are typical, declines hurt you more than gains make you happy so this strategy is "safer" but not always more profitable.

I try to get all emails of trades sent to online subscribers as soon as possible, often BEFORE I make them, but before the market opens the next day is my stated goal. You should use my newsletter to HELP make your decisions after doing your own research.

¹¹ PEG is **P**rice to **E**arnings (PE) ratio divided by earnings **G**rowth rate

¹² Conservative is someone in retirement. Aggressive is someone decades from retirement. Someone age 50, using the new rule of thumb "120 less your age," might be 70% in equities and 30% in fixed income (70:30)

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Disclaimers: This newsletter covers stocks, bonds and mutual funds. I maintain a "paper portfolio" to see how my ideas do over time and I make the best attempt to track my performance as accurately as possible as if I were trading an actual portfolio. I may own all or some of these securities discussed in this newsletter and may buy or sell them at any time for "financial planning" or other reasons not discussed in this newsletter. I have made a best effort to obtain accurate information, but I make no warranties that that the information is accurate.

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