December 2, 2010

Dear Friends,

Happy Holidays! Sorry it has been awhile since my last letter, I have been having a lot of computer problems. Yes, my Mac Book Pro has now crashed a number of times, and they can't seem to get it fixed. The problems have been nothing short of absorbing my spare time.

I have two themes that I will be writing about in the coming year.

Science, Non-science and Nonsense: What is underlying your financial future?

My first theme has as its primary argument, that YOU should know whether your financial future is based on "logical arguments," or science; not complete arguments of logic (non-science); or complete nonsense. My goal is not to "dictate" a particular view of the world, but to help people understand what their investment and financial plans and futures are based on. Your view of the markets, your market assumptions and thesis, may be very different than mine. As you have to accept the risks of your investments, you should base your investments on what you see as sound "science," not nonsense.

To develop your own investment policy statement, based on "science or logic," you first need to lay out your market assumptions. Mine are the following:

1. The world entered the slowing growth future, in 2008; economic and earnings growth will forever be at very low to negative levels globally (+2% to -2%).

2. Growth will collapse when the global baby boom generation retires in mass from 2020 to 2035, and may before this time.

3. The likely permanent impact of the current financial crisis on slowing growth, further than what was forecast by Harvard (2007) and the OECD (1998) based on demographic trends alone, has not even begun to be factored in by the market and participants. These impacts could slow growth much more than expected.

4. Income from most of the roughly $200 trillion in financial assets has dropped to only 0.01% to 3% (see my summer newsletter on "The Great Asset Plagues"), and the only way for many of the fixed income asset yields to increase is for their share prices to drop. Dividend paying stocks can increase their dividends.

5. As with earnings and economic growth in general, the likelihood, given my market thesis, is that growing dividend yields may be difficult to achieve as well. Therefore, higher absolute yielding dividend paying stocks, are likely to out perform dividend paying stocks with low yields, and the "potential" of higher yield growth.

6. Most growth assets, including technology and other growth stocks (i.e. AMZN, AKAM, VMW, etc.) are priced, in my view, very expensively, especially given slowing growth.

7. Given that the total returns (TR) from assets equals a return from income (Y) and from growth (G). In terms of the Standard and Poors 500 (S&P 500) the current yield (Y) is 1.79% (indexarb.com, 11/30/10), and my growth guesstimate for earnings going forward for the next seven years is at best 2% annually, for an expected total return of 3.79% on the stock market (S&P 500). Simplifying, 2% + 2% = 4%, is my scientific expectation for the average annual stock market returns from for the next seven to ten years, based on the science of valuation analysis. This is a similar argument made by Bill Gross in his article "There is no denying the New Normal Now."

8. Returns on growth stocks may exceed these estimates due to other "scientific" forces: behavioral finance and political economics. Behavioral finance, in my view, is best summed up as the impact of "fear and greed" on the markets. As I joke with people, there is nothing but fear and greed affecting the markets. Could greed drive prices higher? Y2K and the recent housing bubble should be sufficient evidence that asset prices could go much higher. Political economics can best be summed up by the forces driving the distribution of wealth and power to the wealthy and powerful. Surely, the financial industry is one of the largest and wealthiest industries on the planet, and the industry has a massive vested interest in driving prices on financial assets upward, regardless of valuation issues. This is what I discussed in my Spring 2007 newsletter in the article titled "Trillions and Trillions dollars vested in selling you over priced assets." Plus, there are the "political" interests in having financial asset prices rise to help stabilize the global economies, potentially benefiting political participants.

Given these market assumptions, right or wrong, I would argue that:

SCIENCE - When 2% + 2% = 4%: Based on permanently slowing earnings and economic growth, low income from assets, the expected returns on all most all financial assets based on the "science of valuation analysis," are in the low single digit range (same as Bill Gross, "There is no denying the New Normal Now"). Only higher yielding dividend paying stocks with yields in the 7% to 10% range have the "potential" of higher returns, based on the "science of valuation analysis." The long-term fair value level for all most all financial assets globally, given my market views above, are where income from all
most all financial assets provides a reasonable risk adjusted return, assuming low to no growth returns.

**NON-SCIENCE - When 2% + 2% = 9% - 10%**: From my perspective, those arguing that stocks will provide 9%-10% returns annually, bonds 5-6%, money market 3%, etc., like they have from 1926-2000 (Ibbotson, etc.), based on historical growth rates over this period and historical yields achieved over this period, are "non-scientifically" forecasting these returns, as they are not taking into consideration the impact of demographic trends and the current financial crisis on slowing economic and earnings growth, and the very low yields on most financial assets in the market. The industry standard models, like Modern Portfolio Theory (MPT), Ibbotson's supply of earnings model, etc., which forecast these types of historically normal returns into the future, in my view, are non-science. They do not take into account the absolutely obvious fact that growth has permanently slowed, due to demographic forces and the current financial crisis. Further, they do not take into account the very low average yields on all financial assets globally. The more asset prices rise, the more yields will drop. Hence, the further asset prices will have to ultimately drop to get to what I see as the long-term fair value level where income from all most all financial assets provides a reasonable risk adjusted return.

**NONSENSE - When 2% + 2% = 12% - 15%**: Those arguing that average annual stock market returns are likely to be 12%-15% into the future, based on arguments that returns like these were achieved after the market collapses in the seventies and early eighties, etc., or based on arguments that these types of returns were achieved during the market bubble years (1980-2007), are spewing, in my view, "nonsense!" Although these returns may be achieved for some short time, due to the impact of "greed" or "political economics" driving prices upward, my belief, given my market assumptions, is that these returns will quickly evaporate, as they did from 2000-2002 and again from 2007-2008. How long could a rally be sustained, especially given my market assumption that the world has permanently entered the slowing growth future, and has not even begun to factor in the impact of the global financial crisis on further slowing growth, beyond what demographic trends would do, is yet to be seen. My guess is that the markets are not likely to sustain another "bubble boom," as Dent argued was possible years ago.

**The Tortoise and The Hare Strategies:**

Given the above market assumptions, right or wrong, and my views about what the science of the markets is today, my preferred strategy is best summarized by the old tale of The Tortoise and the Hare. My investment policy statement is that higher yielding securities (the tortoises) in primarily defensive industries, are likely to win the race to providing a more likely higher total return in the years ahead. The strategy is one of trying to "accumulate shares," versus being focused on "share price gains." If you are receiving a yield of six to eight percent, and reinvesting these dividends to acquire more shares, this strategy, I argue, will have a higher probability of providing a higher total return over time (five to ten years). Further, the more share prices stay the same, or even decline, the higher your expected retirement income potential. The lower the share price the more shares you will be purchasing with reinvested dividends. This is assuming that the dividend paying stocks that you are invested in are capable of continuing to pay their current dividend, or even possibly grow their dividend. Given the uncertainty of when the world may wake up to the fact that "the future may not look anything like the past," the higher yielding dividend paying stocks may prove to have less downside risk than lower yielding and growth investments. Further, declines in higher yielding dividend paying securities share prices may increase the expected total return on these high yielding securities over the next ten years. This is not likely to be the case with lower yielding or growth investments.

Other financial planning suggestions related to these market assumptions are that it may be much easier to reduce your outflow, than it will be to increase your income (both portfolio income and personal income). Given my market belief that investment returns are likely to be low single digits, those planning on achieving 9%-15% returns may find themselves very short of sufficient retirement assets, should my assumptions turn out to be correct. Those that have lowered their expenses and eliminated all debt, may find it much easier to live on very low returns, than those assuming high returns and who have significant debt. Living well on less, which is discussed in "The Simple Living Guide," (Luhrs, 1997) and "Your Money or Your Life," (Robin and Dominguez, 2008) are books that sum up my suggestions about how to financially prepare for the uncertain and potentially difficult future. Get close to your family, friends and your God. If I am correct, we are headed toward challenging times, although I do hope for a less difficult period from 2011 to 2017, than I believe will exist from 2017-2035.

What do you believe about the markets, economy and investments. Please give me a call and we can review your views, assumptions, and beliefs. Remember, I only want to try to help you clarify your beliefs, so that your financial future is based on sound logic or science. Not incomplete information, non-science, and definitely not nonsense!

If your assumptions are that the markets and economies of the world are headed for a similar future to the one that existed coming out of the big 1981/82 recession, I can only hope that you are right and my assumptions prove to be completely wrong. If you are correct, an all growth stock portfolio would seem to be the wise solution, and was the one that I was suggesting during the nineties. A growth stock mutual fund portfolio is suggested by one of the most well known religious based financial gurus for most investors. He could be correct. If you believe he is, then you should invest this way. If he, and those that believe like him, turn out to be correct, then a four growth stock mutual fund portfolio may well provide 12-15% returns annually into the future. If he, and those that believe like him, turn out to be incorrect, then the returns on a four growth stock mutual fund portfolio may well turn out to be like the returns on the NASDQ growth stock index since the top of the market in
2000, ten years ago, down over fifty percent. The NASDQ peaked at 5,132.52 (intraday, March 10, 2000, Wikipedia.org, dot-com bubble), it closed today at 2,549.43 (google.com/finance, 12/1/10), down just over 50% over ten years later. Flat to down significantly, is where I believe growth stock based portfolios will be for the next ten to twenty years, and hence, why they are not appropriate for me, given my beliefs.

You have to accept the fact that your assumptions about the market, and beliefs about what sound "science" says about the future of asset returns, will determine your likely returns. Hard decisions to make, but ones that every one makes, whether they know it or not.

For those that want to see the portfolios that I track, you can login to google.com/finance, then enter my email address - jimmoultrup@gmail.com. My password is - slowinggrowth. Next click on the down arrow at the end of the options at the top left of the page, and click on "Finance." Finally, click on the "Portfolios" options on the left bar. The portfolios that I have set up to watch are located below this selection. You will note a number of different dividend portfolios, if you see any stocks from these lists that sound interesting, shoot me an email and I will look into the company further. I am constantly researching these sources and others for new ideas. This information is not meant to be personalized. I have created these portfolios for educational purposes only. They are not a recommendation to buy, sell or hold any particular security. Neither are they a recommendation to participate in any strategy.

Be sure to give me a call by the first of the year to review your market beliefs and assumptions, along with your financial and portfolio strategies.

May your holidays and New Year be filled with love and happiness of friends and family.

All my best,

Jim Moultrup

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