

July 17, 2008

Dear FI Investment Clients,

The world in which we live has changed. I intend to change our investment strategy to take advantage of those changes.

Inflation.

Inflation has arrived. You know it and I know it. When we buy fuel, food, rent a car, stay in a hotel – everything costs much more now. Inflation is significantly higher than our government is telling us. Over the past decade they have manipulated the formula they use to report inflation. Using the old method of calculation, inflation is twice the rate they now report using their “new improved methods”.

Inflation is a hidden tax on you and me. The intrinsic value of each dollar is less today than it was last year. In other words, every dollar of income that you withdraw from your portfolio buys less stuff this year than the same dollar did last year.

Inflation is going to increase unless the Federal Reserve quickly and significantly increases interest rates and slows down the money printing press. But I don't believe the Fed will do so until inflation is almost unmanageable - for several reasons:

1. The U.S. Government is up to its neck in debt. If the Fed raises interest rates the payments on those debts will go through the roof.
2. The average U.S. citizen is up to his/her neck in debt. If the Fed raises interest rates we will have an unprecedented rash of citizens in financial crisis.
3. Raising interest rates would push our teetering economy into a significant recession.

So how will this play out? The Fed will continue their efforts to prevent a significant downturn in our economic growth by holding down interest rates and continuing to print money – and inflation will continue to heat up.

Inflation has reared its ugly head before. The last significant bout was during the Jimmy Carter years. At that time one of the major culprits was OPEC's price controls over oil. Oil is our source of energy. When energy costs go up, the price of food, manufactured goods and transportation go up. Energy inflation affects everything.

What's different this time? This time the increase in oil prices is not the result of a cartel holding back production. Any country or corporation that can pump oil out of the ground is doing so as fast as they can today. The problem is – the world needs more oil than we can pump. China, India, and a host of other emerging markets have now become significant oil consumers. But world oil production has peaked. So our oil supply can no longer keep up with our oil demand.

This time, there is no cartel to break. We cannot fix our oil problem with geopolitics. Our oil consumption from this point will decrease each year because each year our oil pumps the world over will see less and less oil come up. We're now down to the oil that is hard to get out of the ground. The easy stuff has already been used. We're running out of supply.

How will a decreasing supply of oil affect us? We don't know because we haven't been here before. But it's safe to say that it will inflate the cost of everything. Once the Fed wakes up to the inflation which they have created with their easy money policies, they will find inflation very difficult to tame because the cost of oil will continue to rise no matter what the Fed does.

It appears to me that inflation is here to stay. And it's likely to get way out of control.

How do you survive financially through an inflationary period? What do you do when your currency – the dollar – loses value every year, every month, every day? People change during an inflationary period. They end up buying stuff as quickly as they can because it makes sense to do so. The longer they keep the dollar in their pocket the less stuff it will buy, so they buy quickly and keep less cash in their savings account.

If your currency doesn't hold value during an inflationary period, what will? The standard answer is commodities. What are commodities? Food (e.g., grains), minerals, metals, and oil. As the value of the dollar decreases, these assets will increase in price.

What changes can we make in our investments to protect the value of our portfolios during an inflationary period? For those who are **now in retirement** and use the earnings from your portfolio for monthly expenses, I will do the following:

- Move a significant portion of money out of bonds (which will not keep up with inflation) and put the money into Treasury Inflation-Protected Securities (TIPS). These instruments provide protection against inflation. The principal of the TIPS increase with inflation and decrease with deflation.
- Continue to invest in businesses with strong economic moats which have a significant dividend, whose dividend should increase at the same rate or greater than inflation.
- Continue to look for businesses which are commodity based. Our investment in Compass Mineral (salt and fertilizer components) is a good example.
- Continue to carefully consider businesses based outside the United States.

For those who are **not yet in retirement, but are building your retirement portfolio** I strongly encourage you to keep putting money into the account as fast as you can. I will put the money to work. For these clients I will:

- Continue to invest in businesses with strong economic moats which are selling for significantly less than their intrinsic value – even if they do not pay a dividend.

- Continue to invest in businesses with strong economic moats which have a significant dividend, whose dividend should increase at the same rate or greater than inflation.
- Continue to look for businesses which are commodity based. Our investment in Compass Mineral (salt and fertilizer components) is a good example.
- Continue to carefully consider businesses based outside the United States

The Housing & Credit Bubble

Federal Reserve policies have created yet another problem. Not only have they spent the last decade blowing into the housing bubble with easy-money policies and low interest rates, but with the help of congress, they have shown a willingness to step in to rescue anyone who might fail, not only corporations who make bad lending decisions, but also individual borrowers who make bad borrowing decisions. This creates a moral hazard.

First let's deal with interest rates. What would have happened if the Fed had not manipulated interest rates over the last decade? Rates would have been higher and borrowing would have been more difficult, which would have precluded speculators from buying and flipping real estate – a major player in fueling our real estate bubble.

More importantly, what happens when bankers realize the government will not let a major banking institution fail or a large number of consumers experience foreclosure on their houses? Bankers, knowing they'll be bailed out by the government, no longer have an incentive to require a large down payment and documented income from borrowers. Instead, they are free to feed their greed without fear of consequences. They rush to compete with crazy loans to anybody who will sign up.

That's how we find ourselves where we are today. We no longer have the moral fiber to let people fail. Personal responsibility and living with consequences of our decisions are no longer in vogue. The federal government is going to rush in, pushed by congress, to rescue one and all. You and I, taxpayers who did not make foolish choices, who put a substantial down payment on our house and who demonstrated we have the income to make our mortgage payment – we get to pay for those who made the stupid choice. The rescue money will come from our tax dollars and from the inflation which the government will create by printing money to pay for all the bailouts – the hidden tax.

But what alternative does the Fed have? If they don't rush in with our money to bail these idiots out then we might face a repeat of the banking crises which occurred in the early 1900's in which the entire banking system was closed to stop a run on the banks after several major banks collapsed. What a fine mess we have.

How do we profit from this banking mess? I believe some banks will melt in the next year while a majority will stagger along. But a few who have limited their exposure and arrived at this crisis with strong balance sheets will be able to take advantage of the crisis by buying up other banks at a significant discount. We will tiptoe through this mess by staying invested in those select few banks. They will continue to pay healthy and

increasing dividends and as the dust settles their share price will bounce back to their intrinsic value.

Final Note

Having shared all of the above gloom and doom, it is my experience that when things look darkest we seem to find a way out. And share prices make their greatest gains before we even see the light at the end of the tunnel.

Knowing where we are and how we got here is important. It helps us see our situation clearly and devise a plan to make the best of it. Just as banks which have prepared for the worst will come out stronger in the end, each of us individually needs to be prepared in the event that I am right and we experience a significant rough patch.

For a good review on things you should do to make sure your financial house is in order, I highly recommend you return to our website FIInvestments.com. Get out of debt and have an emergency fund. Those who live paycheck to paycheck suffer greatly when we have economic turmoil. So now is the time to do a self-check and make adjustments in your spending and savings if you haven't done so already.

Hopefully my next report will be more upbeat.

Best Wishes,

Clay Smith
FI Investments