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iSectors®, LLC

Vern Sumnicht, CEO

Inflation Protection Investment Strategies

The Federal Reserve is issuing hundreds of billions of newly printed dollars to finance the $12 trillion U.S. debt at the risk of much higher inflation.

*i*Sectors®, LLC
Vern Sumnicht, CEO

The Federal Reserve prints money to purchase the bonds that the U.S. Treasury can't sell to anyone else.

Increases in monetary base represent newly printed money

We've all heard this definition of inflation: "Too much money chasing too few goods." Theoretically, if a country can keep its money supply under control it will keep inflation under control. Inflation is frequently called an insidious tax because those living on a fixed income, or anyone whose savings are in fixed income investments (bonds), find they lose purchasing power as inflation increases, often unnoticed until it is too late. This article hopes to shine a light on the current dramatic increase in newly printed dollars and propose strategies to protect your savings from the inflation this will inevitably create.

The "monetary base" is a simple tool that can summarize the net monetary actions of both the Treasury and the Federal Reserve. The Monetary Base is reported by the St. Louis Federal Reserve Bank. Darryl R. Francis, former President of the Federal Reserve Bank of St. Louis, in an address to The University of Southern Mississippi, explained how the monetary base can be used to determine the amount of new money printed by the Federal Reserve[1].

> *"… I want to say, it is necessary to introduce an analytical concept we at the Federal Reserve Bank of St. Louis find very useful. In order to summarize in a single series the net influence of all of the monetary actions of both the Treasury and the Federal Reserve, we employ a concept referred to as the "monetary base." … During the past twenty years, growth of the monetary base has been determined primarily by two sources — the gold stock and Federal Reserve credit, an increase in the dollar amount of either of these sources, other things equal, increases the monetary base by an equal amount."*

The U.S. gold stock has not been increased in 2008 or 2009 and therefore, the growth in the monetary base in 2008 and 2009 represents the money printed by the Federal Reserve.

With this information and the following graph of the monetary base from the St. Louis Federal Reserve, you are in a position to appreciate the unprecedented number of newly printed U.S. dollars that have flooded the U.S. and world economies in 2008 and 2009.

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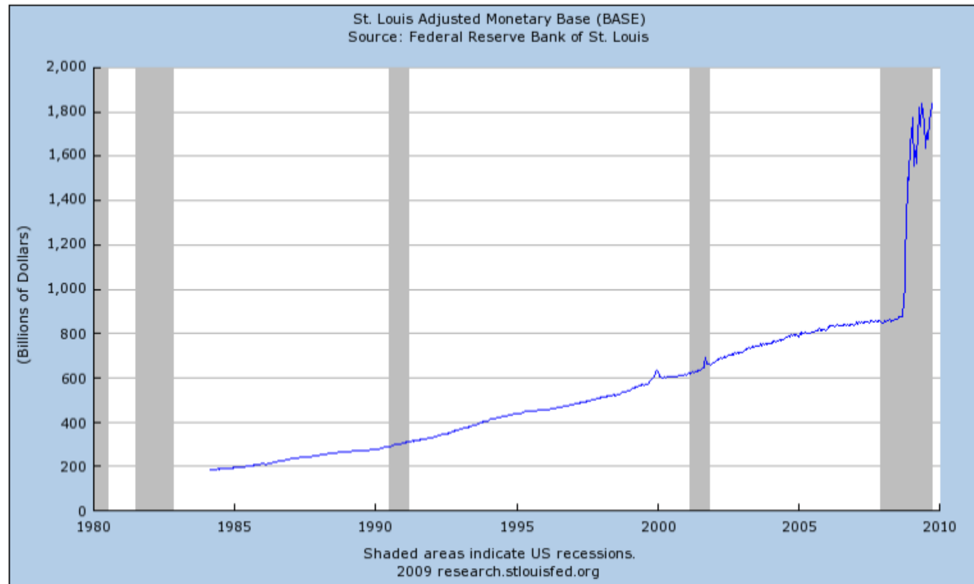
Growth of U.S. Monetary Base 1984 - 2009



With this many newly printed dollars flooding the world in 2008 and 2009 the risk of a dramatic increase in inflation sometime in the next couple of years has increased substantially.

What about the possibility that this new money could be somehow withdrawn from the economy before it causes an inflation problem? Let's go back to the same address by Darryl R. Francis:

> *"In theory, the Federal Reserve would "unwind" after the even-keel operation by reducing its portfolio of securities. In practice, the desire to resist upward pressure on market interest rates, especially during periods of a strengthening economy and rising demands for credit, has militated against behaving according to this ideal. Also, during past fiscal years of very large budget deficits, the Treasury has been involved in some sort of financing the majority of the time, which has left the monetary authorities little opportunity to unwind."*[1]

Simply put, it is highly unlikely to happen. Even rumors of pulling large sums of money out of the economy would cause soaring interest rates and recession. This, as Mr. Francis points out, "leaves the monetary authorities little opportunity to unwind."

Other countries are beginning to realize the repercussions of U.S. monetary policy. They've been purchasing U.S. debt with the profits they've earned from their huge trade surplus with the U.S. for years, leaving them in a difficult predicament. They are at risk of their investments being devalued. Currently, most estimates indicate that the Federal Reserve is printing enough new dollars to fund 50% of the U.S. government debt issued each day … day in … day out. That percentage will increase if countries like China (the largest foreign holder of U.S. debt) reduce their Treasury bond purchases.

Cheng Siwei, former vice-chairman of the Standing Committee and now head of China's green energy drive, said Beijing was dismayed by the Fed's recourse to "credit easing." "If they keep printing money to buy bonds, it will lead to inflation, and after a year or two, the dollar will fall hard. Most of our foreign reserves are in U.S. bonds and this is very difficult to change, so we will diversify incremental reserves into Euros, Yen, and other currencies," he said. China's reserves are more than $2 trillion, the world's largest. "Gold is definitely an alternative, but when we buy, the price goes up. We have to do it carefully so as not to stimulate the markets," he added.[2]

Domestically, experienced investors and economists also have voiced their concerns. In an op-ed article in the *New York Times* on August 18, 2009, Warren Buffett lamented the necessity for the Fed, as the lender of last resort, to intervene so extensively by means of the printing press. In his own words, "The United States economy is now out of the emergency room and appears to be on a slow path to recovery. But enormous dosages of monetary medicine continue to be administered and, before long, we will need to deal with their side effects. For now, most of those effects are invisible and could indeed remain latent for a long time. Still, their threat may be as ominous as that posed by the financial crisis itself."

Bill Gross of Pacific Investment Management Co. (Pimco), which manages the biggest bond fund in the world, advises investors to sell dollar investments "before the central banks and sovereign wealth funds do."

The U.S. government's interagency debt problems

The U.S. has substantial interagency debt which amounts to more Treasury obligations. It is unlikely the U.S. will default on these obligations. However, if the Federal Reserve is already forced to print half the dollars needed to fund our growing debt, they will have little choice but to print additional new dollars to fund the Social Security and Medicare obligations.

US REVENUE FOR 12 MONTHS ENDED AUGUST 31, 2009*	**$2,157,940,000,000**
OBLIGATIONS	
Total Outstanding US Debt (August 31, 2009)*	$11,812,870,150,873
Unfunded Social Security Trust Fund^	$17,500,000,000,000
Unfunded Medicare Trust Funds^	$89,300,000,000,000
TOTAL OBLIGATIONS	**$118,612,870,150,873**

*Sources: * U.S. Treasury. ^Social Security and Medicare Trustee Reports.*

When the value of the dollar falls, we lose purchasing power

The debt situation currently facing the U.S. is not unprecedented. There have been other countries that have faced similar situations in the past. Historically, there have been two ways of coming to terms with an overwhelming debt burden. Either a government can default, which has some very distasteful consequences, or it can pay off the debt with worthless money (i.e. monetize the debt) by printing the dollars needed to pay off the debt.

Money would be considered worthless when it no longer has purchasing power. If the dollar lost its purchasing power, it would mean you can no longer purchase goods and services with dollars. That is, no one will accept dollars or they want substantially more dollars in exchange for various goods and services.

> *Example: If the U.S. doesn't produce any more goods or services, but it prints 10 new dollars for every 1 old dollar, that would increase the number of dollars in the economy by 10 times; in theory, it would now take 10 dollars to purchase what 1 dollar would have purchased previously. Another way to look at the effect of printing ten times as many dollars -- the dollars you held in CDs, money markets, treasury bonds, etc. are now only worth 10 cents, or it takes 10 dollars to buy what 1 dollar would previously buy.*

Value of U.S. Dollar Index Spot Price 1999-2009 Weekly

Source: **Safe Harbor No More**, Sprott Asset Management, September 2009

When the rest of the world sees the Federal Reserve printing money like the proverbial "drunken sailor," the U.S. dollar begins to signal inflation and goes from the flight-to-safety currency to the currency everyone wants to sell before it loses any more value (purchasing power). This drop in the value of the dollar can be seen in this graph above of the U.S. dollar index spot price (NYBOT—DXY). Since 2001, the dollar, relative to a basket of other international currencies, has fallen by 35%. This longer-term falling dollar trend correlates with the unprecedented monetary base increase discussed earlier. In addition, see the graph of Powershares Bullish Dollar Index, symbol (NYSEArca--UUP) below. This Bullish Dollar Index is down 10% just since March-end, 2009. As the prospects for inflation grow, this negative trend for the dollar could continue at this rate, or even accelerate.

Powershares Bullish Dollar Index (UUP--NYSE)

Chart courtesy of BigCharts.com

What should you do with your own portfolio?

Your U.S. dollar denominated savings and fixed-income investments are no different than those of foreign countries. Like them, you should consider investing your savings into something besides potentially worthless paper money, cash equivalents or fixed income investments (i.e. bonds). After all, if they don't want their principal and interest payments at risk of turning into potentially worthless paper, why should you?

What investment strategies can protect the purchasing power of your wealth from inflation? To begin, let's consider some of the less liquid investment strategies. **Gold and silver coins** are excellent hedges against the dollar falling and inflation. As an example of how well gold holds purchasing power, I've read that when gold was $35 dollars an ounce, you could buy one very nice men's suit for $35 or an ounce of gold. Today, at $1,000 an ounce for gold, you can still buy one very nice men's suit for $1,000 or one ounce of gold.

Precious metal coins are generally better to own than gold or silver bars. The problem with bars is you need to have them tested (assayed) to be sure they are bars of silver or gold, and that testing can be somewhat expensive. Everyone recognizes coins and generally will accept the gold or silver content within them. The biggest problem with gold and silver coins is that they are heavy to transport and you need a safe place to store them. Here are a couple examples: $100,000 of gold is 100 ounces or 6.5 pounds of gold. At $16.25 per ounce of silver, a bag of $1,000 face value, pre-1964, 90% pure silver coins cost $11,700, which equals about 715 ounces or about 50 pounds. These silver coins are known as "junk" silver. That is, they have no value as rare coins and collectors generally aren't interested in them. However, junk silver coins are excellent for financial emergencies. Example: If there was a crash in the dollar or hyperinflation, you might not find anyone that will take your dollars in exchange for food. On the other hand, a pre-1964 silver dollar made of 90% silver would likely be accepted by most farmers for a bushel of potatoes, a hammer and nails, car tires, seeds, etc.

Real estate is another good example of something that can rise nicely in value during a period of inflation. There seems to be endless opportunities in real estate right now. However, you need to be able to buy without borrowing a lot of money. That is, you need to be able to hold onto your real estate for the long-term. You can borrow to buy at these low rates, and you may be able to pay off the loan with worthless (i.e. highly inflated) dollars if you can continue to make your payments on the loan. The bottom line is, don't buy anything you can't really afford to hold onto longer term.

That said, real estate has been significantly reduced in price today (as of October, 2009) and you can borrow for 30 years at around 5% annual interest. These rates are likely being kept artificially low by the Fed right now to stimulate the economy. If you can afford it, **farmland** that you can grow food and raise animals on might be a good purchase. An interesting way to purchase a small farm might be to buy a remainder interest in a farm. This could be done, for example, by finding a farmer that is older, whose children don't want to farm, that may need money now, but plans to live on the farm the rest of his life. He may be willing to sell you a **remainder interest** in the farm today. By determining life expectancy, agreeing on a price and interest rate, the farmer could start receiving money monthly now, you get all the inflation increase in value, you don't need to care for anything on the farm now and after the farmer dies, his family doesn't need to sell a farm; you simply own it.

My advisory firm recently formed a partnership and purchased a large parcel of **forestland** in Tennessee at a bankruptcy auction for approximately one-third of its appraised value. Our specific reason for purchasing the land was as an inflation hedge (not just to flip the property because of the depressed price). In addition to the immediate profit we could book if we chose to "flip" the property along with the potential for the land to hold value should inflation become a problem, the parcel also holds timber value and development possibilities that we believe may offer significant return potential for our clients.

Historically, a long period of low inflation brings about opportunity in **colored gemstones (rubies, sapphires and emeralds)**. Remember, diamonds, gemstones and precious metals are crisis hedges. Stocks and bond have a possibility of becoming worthless. This can't happen with something you can hold in your hand like gemstones or precious metals.

If the eventual outcome of the U.S. government's stimulus plan is hyperinflation, many economists believe that gemstones would be a good place to have some of your assets.

Top quality collector gems are limited and this helps limit downside price risk. In addition, most collectors are long-term and seldom "forced to sell." There has been decreasing collector demand in the last year. This is likely a function of fear and lack of liquidity. As with any investment, crisis for some is a time of opportunity for others. As they say, "a good time to buy is when blood is running in the street."

Many of these assets I've mentioned, including real estate, farmland, timberland, colored gems and others like diamonds, art, rare stamps, rare books, wine, Persian rugs or rare coins may be great <u>real assets</u> to purchase after long periods of low inflation or prior to periods of high inflation. However, you need to be very patient; these investments take time to locate and careful research before buying or selling. They require that you develop a lot of specialized knowledge or engage someone who has the knowledge to determine value of these assets. You buy the assets only if you can afford to hold them indefinitely, if necessary. It is more likely than not that you'll lose money on this type of asset if you're ever forced to sell.

For many investors, without the specialized knowledge, wealth, and/or time to accumulate land, gems, rare art, etc., liquid inflation hedges may be more appropriate. Exchange-Traded Fund (ETFs) are investment vehicles that have been developed in the past few years that now provide investors with the ability to quickly and easily access instruments that can help protect a portfolio from inflation and a falling dollar. These ETFs offer daily liquidity, they require no or little minimum investment, no accreditation (like a net worth of $1 million), they are all registered securities and there are no performance-based fees or complicated K-1 tax forms. These investments allow you to buy or sell daily, or as you believe appropriate for your situation as things change.

If you're in a financial situation that dictates the investments you own need to provide you income to live on, consider inflation-protected bonds. The easiest way to purchase U.S. inflation-protected bonds is to purchase the Exchange-Traded Fund (ETF) **iShares Barclays inflation-protected bond index, (NYSEArca--TIP)**. Similarly, for international bonds, there is an ETF called the Spiders – **SPDR DB International Government Inflation-Protected Bond Fund Index**, **symbol (NYSEArca--WIP)**.

Alternatively, or in addition, you may want to simply own bonds denominated in other currencies than the dollar. This would allow you a hedge against the falling value of the dollar. Good choices here might be the Spiders- **SPDR Barclays International Treasury Bond Index ETF (NYSEArca--BWX)** and/or the iShares – **JPMorgan Emerging Markets Bond Index ETF (NYSEArca--EMB).**

An interesting investment for getting some money invested in other currencies, while providing some income, might be **Barclays iPath Optimized Currency Carry Index ETN, (NYSEArca--ICI)**. This ETN use a strategy called a "Carry Trade." The idea of currency carry trading is to borrow funds in a currency with low interest expense and invest the funds in a currency paying high interest. The difference between the interest income and interest expense is the investor's return. Prior to the advent of exchange-traded funds and notes, this was a relatively sophisticated strategy, unavailable to individual investors.

An old favorite, when it comes to hedging inflation, is real estate both here and abroad. As Will Rogers used to quip, "Buy real estate, they ain't making any more of it." The fact that there is a limited supply, unlike flat currency, helps real estate retain its value throughout periods of inflation. Good options here may be domestic REITs, represented by the **iShares DJ Real Estate Index ETF (NYSEArca--IYR)** and/or international REITS such as the **SPDR Wilshire International REITs Index ETF (NYSEArca--RWX)**. REITs also provide healthy dividend payments.

Certainly, any "real asset" which includes most commodities would be considered an inflation hedge. A couple of good ideas for broad-based, non-leveraged, long-only commodity funds may include **iShares iPath Dow Jones AIG Commodity Index**, **an ETN (NYSEArca--DJP)** and the index put together by the famous investor Jim Rogers. An ETN representing this index is available from Elements and is called the **Rogers International Commodity Index, (NYSEArca--RJI)**. Rogers uniquely weights the commodities in his index based on their use/demand throughout the world rather than by capitalization, which is more common.

Master Limited Partnerships (MLPs) are another real assets type of inflation hedge with a nice yield as well. MLPs own infrastructure like gas and oil pipelines. The yield comes from the lease income they receive from those who use the pipelines. A good way to invest in MLPs is by purchasing **Kayne Anderson MLP Investment Company**. **This is a non-diversified,**

closed-end management investment company (NYSE--KYN). The Company's investment objective is to obtain a high after-tax total return by investing at least 85% of its total assets in energy-related Master Limited Partnerships (MLPs) and their affiliates, and in other companies that, as their principal business, operate assets used in the gathering, transporting, processing, storing, refining, distributing, mining or marketing of natural gas, natural gas liquids, crude oil, refined petroleum products or coal.

Of course, as inflation increases and the value of the dollar decreases, energy prices quoted in dollars increase dramatically (as we've been seeing recently with oil). This, in turn, increases the interest in, and value of, alternative energy. A convenient way to own a global index of alternative energy investments is through **Market Vectors Global Alternative Energy ETF (NYSEArca--GEX).** GEX seeks to replicate, as closely as possible, the price and yield performance of the Ardour Global Index (Extra Liquid) AGIXL (the Index) by investing in a portfolio of securities that generally replicates the index. GEX is intended to give investors a means of tracking the overall performance of a global universe of listed companies engaged in the alternative energy industry.

As we saw above, when the Federal Reserve decides to print money to increase the money supply (also known these days as quantitative easing), inflation is likely right around the corner. To avoid losing purchasing power, investors sell dollars and move to "real assets" that will retain value during a period of inflation. This selling of dollars causes the value of the dollar to go lower, which exacerbates the inflation problem in a vicious cycle which can be difficult to get back under control. A good way to hedge your dollar-based holdings is by purchasing **PowerShares DB US Bearish Dollar Index (NYSEArca--UDN)**. The investment seeks to track the price and yield performance, before fees and expenses, of the Deutsche Bank Short US Dollar Futures Index. The index is comprised solely of short futures contracts. The futures contract is designed to replicate the performance of being short the U.S. Dollar against the Euro, Japanese Yen, British Pound, Canadian Dollar, Swedish Krona and Swiss Franc.

To put in perspective, what has been happening to the dollar in just the last six months (through September, 2009) take a look at the graph below. The graph compares the price performance of PowerShares DB US Dollar Index Bearish (NYSEArca--UDN), in blue, to its sister ETF, the PowerShares DB US Dollar Index Bullish (NYSEArca--UUP), in red. If a picture is worth a thousand words, this tells us how the world really feels about the Federal Reserve printing billions and billions of new dollars. The question now may be, "Is a word to the wise sufficient?"

Comparison of USD Short vs. USD Long ETF

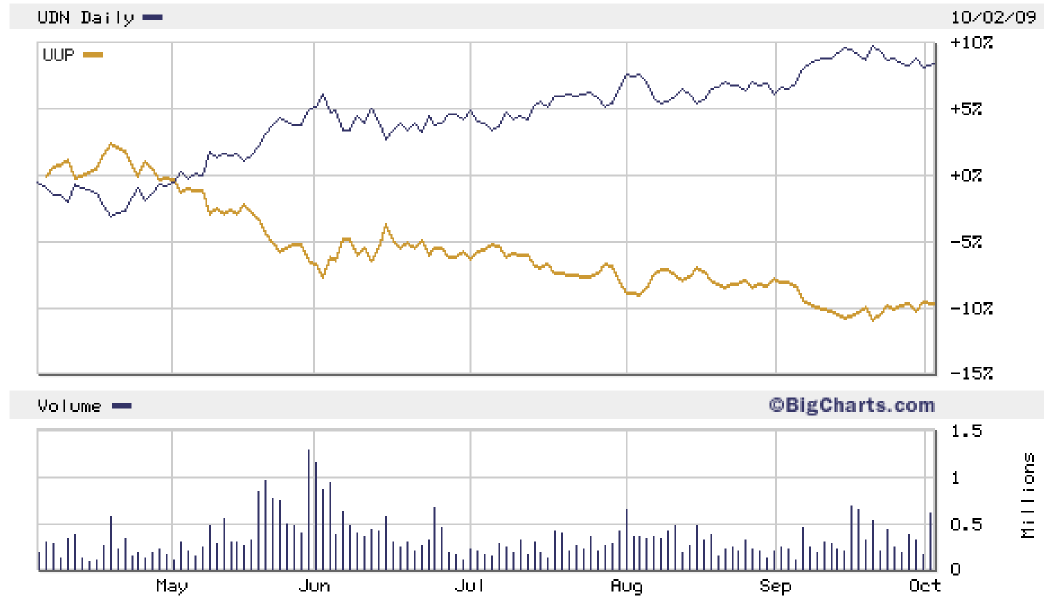


Chart Courtesy of BigCharts.com

Timber is another commodity that can be purchased as an ETF. The **Claymore/Beacon Global Timber Index (NYSEArca--CUT),** which represents the global timber market seeks results that correspond generally to the performance of the Clear Global Timber Index. The fund normally invests at least 90% of total assets in common stock, American depositary receipts, and global depositary receipts that comprise the Clear Global Timber Index. It seeks a correlation over time of 0.95 or better between its performance and the performance of the index.

An investor that intends to hedge against inflation would be well-advised to hold precious metals. Unfortunately, because of their weight and value, precious metals are somewhat cumbersome to safely store or move. **Central Fund of Canada (AMEX--CEF)** is a closed-end mutual fund; this fund trades like a stock on the exchange. Central Fund's purpose is to hold gold and silver bullion on a secure basis for the convenience of investors in the shares of Central Fund. At least 90% of Central's assets are Gold and Silver bullion at all times.

For purposes of diversification and leverage, an ETF that owns gold mining stocks can also be an excellent precious metals hedge against inflation, such as the **Market Vectors Gold Miners ETF (NYSEArca--GDX)**. The investment seeks to replicate as closely as possible, before fees and expenses, the price and yield performance of the AMEX Gold Miners Index. The fund normally invests at least 80% of its total assets in common stocks and American depositary receipts of companies involved in the gold mining industry. The fact that gold only costs $350 an ounce to mine, yet the market price of gold is about $1,000 per ounce, is why owning the mining companies leverages the rising price of gold.

An inflation hedge that can improve returns, while reducing risk because of its low correlation to other asset classes, is the **Rydex Long/Short Commodities Fund – Strategy H (RYLFX)**. This is a relatively new fund; however, it is based on an index with a longer-term history that

measures trends in the commodity futures markets on a daily basis. The fund invests substantially all of net assets in commodity-linked instruments whose performance seeks to provide investment results that match the daily performance of the JPMorgan Core Commodity-Investable Global Asset Rotator Sigma Long-Short Total Return Index.

The iSectors® Inflation Protection Allocation

In an effort to assist investors and their advisors in developing and managing a balanced allocation to protect their portfolios from inflation, iSectors® has developed an allocation called the iSectors® Inflation Protection Allocation. My team and I researched various inflation-targeted securities (including many of those mentioned above) and, after running some optimization analyses, we created a unique allocation of liquid securities that offer inflation protection potential. This allocation allows advisors and their investors to simply and easily purchase and hold a diversified basket of inflation protection securities that is inexpensive, professionally managed, liquid and fully transparent.

Conclusion

The inflation scenario is a dynamic situation we face throughout the world today. It seems the news changes every day. In addition, new securities are being developed with new risks and new potentials. Staying aware and connected can mean these changes create new opportunities, not threats to your financial health.

As with any investment strategy, you should retain the services of a qualified, independent registered investment advisor, to help you assess the appropriateness of any investment. An independent registered investment advisor can help you identify unique risks specific to your current financial situation and future financial needs, to help ensure that your investments are appropriately allocated and will help you reach your financial goals.

Footnotes

1) How and Why Fiscal Actions Matter to a Monetarist
An address by Darryl R. Francis, President, Federal Reserve Bank of St. Louis, at The University of Southern Mississippi, Hattiesburg, Mississippi, May 3, 1974

2) Evans-Pritchard, Ambrose. (September 6, 2009). China Alarmed by U.S. money printing. Retrieved on September 15, 2009 from: http://www.telegraph.co.uk/finance/economics/6146957/China-alarmed-by-US-money-printing.html

Vern Sumnicht has 25 years experience as a successful financial planner and has been recognized for four consecutive years by "Worth Magazine" as one of the Nation's Top Wealth Advisors. Vern and his team, with more than 100 years of collective post-graduate education, certifications and experience, developed iSectors® diversified ETF allocation portfolios. For more information about iSectors® ETF allocation portfolios, visit www.iSectors.com, email Vern at vern@isectors.com, or call 1-800-iSectors.

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