



ANDRESEN AND ASSOCIATES

FEE ONLY INVESTMENT ADVISOR

P.O. Box 1434 Salinas, CA 93902
(831) 758-1575 or 1-800-345-9644
www.andresenassoc.com

March 10, 2008

Stormy Weather

On the cover of the March/April 2008 issue of *Foreign Policy*, the headlines scream: “THE COMING FINANCIAL PANDEMIC Why America’s Economic Crisis Will Infect The World.” The article reads in part, “*It’s time to face the truth—the US economy is no longer merely battling a touch of the flu; it’s now in the early stages of a painful and persistent bout of pneumonia.*”

Meanwhile, the March 10th issue of *Forbes* magazine contains a very different opinion. Noted veteran economist A. Gary Schilling writes that inflation is not a danger at all. In his article, entitled “Sell Commodities”, he opines that we are entering a long and deep recession, and all those inflated metals, grains, foodstuffs, and oil are going to take it on the chin price-wise.

And then for something completely different, we have last month’s Producer Price Index Report indicating a growth rate of 7.7%. This is the highest monthly inflation rate in more than 25 years. At this rate you will need to double your income in nine years to retain your current spending power.

A person could be forgiven for a bit of pessimism after reading all this. It’s ugly news, and ugly talk. But before we run screaming down the street, it’s worth considering what all this really means. The writer in *Foreign Policy* is saying one thing, the economist in *Forbes* is saying something different, and the historical data on inflation is saying something entirely different from both of them. What’s an investor to do?

Let’s take a closer look at the risk of inflation. Some key ingredients to create inflation are a booming global economy, a declining dollar, and inflated commodity prices. All of these are happening now.

Inflation is a statistic which reflects an increasing cost of living. It is measured very imprecisely by the PPI (Producer Price Index), which measures the cost to make things, and CPI (Consumer Price Index), which measures the cost of living for consumers, aka us.

Inflation is one of the big financial risks you face as an investor. Even a little inflation corrodes your spending power over time. For example, the CPI rate for the last fifteen years has been a little under 3%. That doesn’t sound like much, does it? But those 3% annual price increases have cut your spending power in half.

Normally, the tonic for rampant inflation is for the central bank to radically slow the economy down by raising interest rates. This brutal solution worked on the oil-induced runaway inflation of the 70’s and early 80’s when Fed chairman Paul Volker raised interest rates into the teens and induced two back to back recessions.

However, our current Fed chairman, Ben Bernanke, is an academic with years spent studying the Great Depression of the 1930’s. He is acutely aware that we may already be entering a recession, so he’ll be loathe to raise interest rates. Then we might be facing a stalling economy and oil-driven inflation simultaneously. This combination of a stagnating economy and inflation is called “stagflation”. Brutal though it may seem, the cure is a recession to strangle the speculators and restore equilibrium.

And, since inflation is self-immolating, it usually kills the economy within a few years. The longest time in history that inflation has stayed above 7% was 52 months, from August 1977 to December 1981.

Back then the economy was much hotter than it is now. We can expect a stall much earlier. So what are we going to do about this?

Most importantly, let's realize that we really don't know what will happen in the future. So when you see someone putting all their money in gold or rushing out to short the cocoa market, keep in mind that he or she is guessing. Even temporarily going to cash is guessing and the risk of missing the recovery is genuine. Guessing is gambling. Your life savings should not be treated like casino cash.

Meanwhile, mutual fund managers are not standing about with their thumbs in their ears: they are trying to figure it all out as well. Since you are in mutual funds, you have hired all that brain power. They have a history of success. So mutual funds, not direct investments, make the most sense now. Let the mutual fund managers do their jobs.


During the crest of an inflationary cycle, it is very hard to make money in anything. Real estate traditionally does well...but this time it's been hammered. Commodities like metals and petroleum usually do well...but this time they are already overpriced. Bonds are wonderful in a recession but they fail badly if inflation burns on. Stocks may take a beating when inflation is running wild, but long-term returns to the stock market beat inflation hands down.

This kind of performance is key to our strategy (see graph). To genuinely become as wealthy as possible, our investments must outperform inflation in the long-term. Staying the course and not guessing is crucial.

I think the best course now is to focus on the long-term. We know this time of inflation and uncertainty won't last, if only because a recession will end it.

My plan is to stay very diversified in mutual funds which provide opportunities wherever the economy goes. Some of what you own is relatively risky, because I don't want to miss the upturn. Some of what you own is defensive, because I am not sure what will happen.

Meanwhile, I am still looking for opportunities to snap up financial stock ETF's and real estate ETF's. Both should do well in the long-term. They are now selling at bargain prices. Since they have been thrashing early purchasers, I am proceeding cautiously with them now.

We are in a financial storm. It is natural to want to fight against the wind and the waves as they toss and confuse us, but this would be wasted effort. The safest tactic is to go with the wind and let it blow itself out. Staying afloat and as dry as possible is a worthy objective. History tells us the storm will pass in time. Currently, patience is key. 

Investment Growth

Item(s) from 9-01-1993 to 2-29-2008

Fund	Cumulative Return %	Annualized Return %	Max Front Load %	Max Back Load %	Expense Ratio %	Amount at End of Period \$
Vanguard Total Bond Market Index	132.11	5.98	NA	NA	0.20	23211.19
Longleaf Partners	437.60	12.30	NA	NA	0.90	53759.71
First Eagle Overseas A	596.31	14.32	5.00	NA	1.14	69630.97
Vanguard 500 Index	270.16	9.45	NA	NA	0.18	37016.26
Excelsior Value & Restructuring	687.83	15.30	NA	NA	1.05	78783.32
Vanguard Wellesley Income	217.70	8.30	NA	NA	0.25	31769.99
USTREAS CD Sec Mkt 6 Mon	86.54	4.39	NA	NA	NA	18654.21

Initial Value: \$10,000

