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# Investor's HOTLINE

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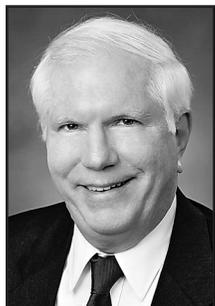
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January 2008

Exclusive sound-wealth wisdom from the world's leading financial experts

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## Forenotes from JOE BRADLEY

### RETIREMENT ANNOUNCEMENT

1. It's been 32 years since Joe began *Investor's HOTLINE*, and he will turn 65 in April; it's time for him to welcome a new chapter in his life.

2. The final issue of *Investor's HOTLINE* will be the April 2008 issue, releasing on March 28, 2008.

3. Active members at that time will receive these additional materials along with the last monthly issue: (1) a full-length, farewell interview of Joe in which he shares his parting observations and (2) a searchable archive of all issue summaries, 2002–2008, on CD-ROM.

4. Joe has interviewed more than a thousand financial experts; many of them, like many IH members, have become friends; he will miss doing the interviews and the personal communications but not the deadlines and other details of running the business.

5. He expects to have an active retirement—with a little more adventure than other phases of his life; immediate plans are to smell the roses, do more traveling and spend more time with family and friends.

6. He will still be investing and coordinating his own portfolio of investment managers and will stay plugged into his guru contacts.

7. Joe invites members to stay in touch—with investment questions, to exchange opinions or just to say hello.

8. Enclosed with this issue, is a notice outlining the closure details that apply to you; if your current membership expires before April, be sure to renew for the remaining months and Joe's *Investor's HOTLINE* curtain call.

### January Guests

1. **Mark Sellers** of Sellers Capital, LLC returns to update some of his previous recommendations and offer his insight on what makes a great investor.

2. The net annualized performance of the Sellers Capital Fund, his long/short equity hedge fund, from inception in August 2003 through Sept. 2007 was 34%, and 45% from Jan. through Nov. 7, 2007.

3. **Mark Skousen** introduces his newest bestseller, *Investing In One Lesson* and highlights its key points about the differences between Wall Street and Main Street and how to apply them for investment success.

4. According to Eagle Publishing, Skousen's high-yield recommendations scored an average of 17.54% in 2004, 2% in 2005 and 22.71% in 2006; most of his recommendations from July 2007 have shown excellent performance to date.

5. Release date is Friday, December 21; the interviews were completed the week previous.

### Online Videos to Enjoy

1. Adrian Day suggests two enlightening videos; one is the Capitol Hill interrogation of Fed Chairman Ben Bernanke by Congressman Ron Paul on the bubbles and bailouts that are wrecking the value of the dollar—<http://bullnotbull.com/bull/node/58?ref=patrick.net>.

2. The second reviews Paul's principled, anti-big-government stance; one must concede his consistency regardless of agreement with his positions—[www.youtube.com/watch?v=FG2PUZoukfA](http://www.youtube.com/watch?v=FG2PUZoukfA).

3. A third video recommended by financial analyst Garret Jones is an hilarious explanation of the subprime fiasco; the skit has surprising clarity except for throwing primary blame on hedge funds, which, as explained by IH guests, were minor players compared to financial institutions, including the big banks—[www.youtube.com/watch?v=SJ\\_qK4g6ntM](http://www.youtube.com/watch?v=SJ_qK4g6ntM).

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### Traits of Great Investors

1. What distinguishes great investors, like great CEOs, is the ability to think differently; only about 2% qualify by thinking outside the box.

2. Playing like everybody else allows one to keep up but not to get ahead; great investors tend to be contrarians—they can distinguish when it is okay and not okay to go along with the crowd.

3. Being obsessive about investing—i.e., devoting long hours and thinking about it all the time—is another requirement.

4. Great investors scrutinize what they have done wrong and try not to repeat mistakes more than a few times—it is very difficult to learn on the first try; avoiding the big mistakes generally leads to success.

### Investing with Conviction

1. Conviction leads to not selling in panic and also affects the size of positions one takes; limiting the size of bets to a few percent amounts to throwing numerous darts.

2. The Kelly formula developed by a mathematician in the 1950s indicates that a 2% position equates to a belief in a 51% chance of winning vs. a 49% chance of losing.

3. Sellers believes that serious investors should take big bets (8%–10%) or no position at all; average investors with limited time to commit to

the process should hold a portfolio of 15–25 stocks for diversity.

4. With a mutual fund or hedge fund, investors are buying an expert to manage their money; chances are investors cannot get to know fund managers well enough to commit 25% into one fund—a reasonable allocation is 5%–7% into 10–15 different funds.

### The Investment Thought Process

1. Great investors use both the logical and intuitive sides of their brain, but they are born with that ability or at least develop it early in life; they need to be capable of detailed mathematical analysis yet still see the big picture and apply judgment.

2. An experienced investor can recognize when a decision is rooted in fear; usually fearful decisions are hasty and poorly thought out; Sellers tries never to make a decision out of fear.

3. Sellers does act on greed in the sense of taking big positions when he recognizes that the risk-reward ratio is strongly in his favor; however, he does not hold onto high performers that become overvalued.

4. Great investors can handle volatility without panicking; pulling money out at a bottom or committing money at a top are mistakes.

### Advice for the Rest

1. Average investors should keep their expectations reasonable; if they pick their own stocks, they should look for well run companies with good, honest management and wait to buy until a stock hits a 52-week low.

2. Aim to buy a basket of 20–25; then hold on; an example is Lowe's (LOW), a good company, cheap now but not for company-specific reasons.

3. Following such a patient approach should lead to above average portfolio performance.

### Hedging a Big Market Drop

1. In his fund, Sellers hedges the portfolio by shorting overvalued stocks or more commonly hedging the market by buying puts on the indexes as insurance.

2. If the market goes up, the puts expire worthless, but if the market goes down, they can go up an unlimited amount.

3. An easy strategy for average investors to partially hedge a portfolio is to short ETFs, a bet that the market will go down; the play can go up or down an unlimited amount, so it is not as efficient a hedge as using options; investing in an inverse index amounts to the same thing.

4. Sellers is cautious about shorting and advises investors instead to hold more cash, which stays flat and has power for buying screaming bargains.

5. Avoidance of losses is the key to long-term compounding; the goal for each individual stock purchase is not to lose money—doing that across an entire portfolio ensures success.

6. By taking out the huge losers, investors tend to outperform the market, which is a mix of big losers and big winners.

### Sellers' Approach

1. In his fund, Sellers truncates even more to eliminate the big winners, too; he focuses on the safer stocks with a skewed risk-reward.

2. Sellers takes positions as large as 10%–20%, so he needs to know the companies and their managements, the tax laws, political environment, even the culture; his circle of confidence is strictly North American stocks, primarily US.

3. Investors should choose managers with a variety of circles of confidence; forecasts for stronger growth in foreign markets and a decline

in the USD are compelling, so investors might want to commit more money outside the US than inside—but be careful about bubbles, especially in China.

### Favorite Picks

1. Sellers has switched preference from Home Depot to Lowe's; Lowe's has come down to near the price of Home Depot, but the company has more growth opportunity and a better, more focused management team; the LOW balance sheet is strong, so there is no risk of bankruptcy.

2. Under the worst-case scenario, fair value for LOW is about 20; it is a buy for new positions up to 22, though paying 24 with the intention of holding long term is reasonable.

3. Turnarounds are hard to gauge with company-specific problems, but a company like LOW, which fits the criteria for buying the best company in an out-of-favor industry, stands to gain market share in hard times.

4. Home Depot levered up to buy back shares at 37, and the stock (now around 28) has less flexibility than Lowe's.

5. Contango Oil & Gas (MCF) is an example of an asset play—the company's earnings are not important because it has oil and gas wells that could be liquidated above the current market price.

6. Since recommending the stock in June 2007, Sellers has gained even greater respect for its CEO, whom he calls the Warren Buffett of the oil and gas business.

7. MCF is akin to a venture capital fund focused on natural gas exploration and production; the stock sells at about 47, but its fair value is around 60.

8. MCF, which is moving ahead with plans to sell some or all of its parts, has a greater chance than LOW of doing well over the next year; MCF's recent sale of reserves brought a much higher price than expected; the company valuation was up \$10 a share, but the stock rose only about \$5.

### What Sellers Is Not Buying

1. The mentality is different for dealing with distressed or levered stocks; Sellers is not buying financials right now, not because he thinks they will be cheaper later, but because of severe downside risk—a bank can go all the way down to zero.

2. Financials look cheap on the surface, and there surely are great opportunities among them; however, Sellers cannot tell which companies are the opportunities and which are traps—MBIA appears to be a trap.

### Updates on Other Past Favorites

1. Fuel Tech (FTEK) was positioned to benefit from the worldwide demand for pollution abatement in coal plants; the stock is not low risk, and new information suggests that its process is not as competitive as it originally appeared; consider the stock a sell.

2. Sellers never developed full confidence in the management of Western Union (WU), so he sold it and transferred money into Zimmer (ZMH), a medical device company out of favor at the time.

### The Danger of Selling Too Soon

1. McDonald's (MCD) went up a lot, and Sellers took profits; he thinks he sold too soon—a weakness he admits he is trying to correct.

2. His discipline is to sell all or most of a position when a stock reaches fair value, but being too conservative in calculating fair value is a common problem for value investors.

3. Sellers is oriented toward figuring how much he can lose on a stock, but he recognizes the need to do more on calculating the upside.

4. Another example of a stock sold too soon was MasterCard (MA); Sellers doubled his money but could have doubled it again; fair value for MA now is around 180.

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### The Number One Lesson

1. Wall Street is not Main Street—the business of investing is not the same as investing in a business; Skousen's new bestseller, *Investing in One Lesson* (IOL), explores why there is a disconnect between the two.

2. The day Skousen started writing the book, Yahoo! announced an 83% increase in quarterly earnings, and the stock dropped 13%; the market assumed that the company could not maintain that pace; Yahoo! (a very good company) has come close to doing so with 50%–60% earnings, yet the stock continues to flounder.

3. There is much more volatility in the market compared to fundamental, underlying factors; Skousen charts real GDP growth versus the S&P 500 from 1990 to 2007 (see p. 22, IOL).

4. Both GDP and the S&P 500 start and end at the same level, but the stock market dramatically spikes up and plunges down before recovering to GDP level.

4. The three basic reasons for the disconnect are: (1) the company is subject to the daily auction of its stock, (2) only a small number of buyers and sellers determine the stock price (their marginal analysis reflects investment bias); (3) stock prices are always forward looking.

### The Investment Solution

1. IOL also presents an investment strategy for minimizing the impact of the disconnect and avoiding deep losses; Skousen's approach is based on the work of Jeremy Siegel at the Wharton School as documented in his book, *Stocks for the Long Run*.

2. According to Siegel, what determines the best stock values over time is not earnings or prospects but dividends; Skousen also finds support for a dividend investment approach from other reputable sources.

3. A sophisticated refinement of the strategy involves making selections among seven categories of non-correlated dividend-paying stocks.

4. During the last major bear market (2000–2003), investment exclusively in an index of dividend-paying stocks broke even; investment in non-dividend-paying stocks (e.g., the Nasdaq), lost 50%–60%; IOL also includes the Siegel graph making this powerful point.

### Responses to Negative Arguments

1. Skousen concedes that the dividend strategy misses the early winners in a bull market, but early winners that hold their value tend to be a small percent of the total universe of stocks; e.g., 80% of tech stocks

never earn any money, so their prices collapse.

2. Separating poorly managed companies that declare dividends from the good companies is a matter of looking for high-quality companies with strong earnings; on the other hand, paying dividends is strong motivation for weak companies to turn their situation around.

3. Double taxation is a problem, but it is minimized with the 15% tax rate; Skousen is optimistic that the 15% rate will be maintained by Democrats or Republicans.

4. Warren Buffett and investors in Berkshire Hathaway get dividends indirectly from investments such as Coca Cola, which has been paying a rising dividend for a long time.

5. Although dividends are subject to being cut or discontinued, traditionally only about 5% of dividend-paying companies do so—the percentage has been higher for the mortgage REITs lately; Skousen doubts that Citibank, Bank of America and others will cut dividends, but the risk is there—no investment is perfect.

6. The efficient market theory is a legitimate concern—dividend-paying stocks have been undervalued, but if they become hot, they would lose that advantage; the market is not to that point yet.

### The Power of Dividends vs. Growth

1. Investors tend to favor growth-oriented stocks over dividend-oriented stocks—Siegel calls this preference “the growth trap;” e.g., although IBM outperformed Standard Oil and Exxon over 50 years by economic and financial measures, Big Oil outperformed when reinvestment of its high dividends are taken into account.

2. Because investors under-appreciate good, high-dividend paying stocks, stodgy companies like railroads, oil companies and banks can be bought so cheaply that with reinvestment of dividends, investors come out ahead of investing in strong growth companies.

### The Swenson Strategy

1. In managing the Yale endowment fund, the top-performer of all the college endowment funds, David Swenson applies a strategy of non-correlation investing; he looks for stocks, countries and sectors going contrary to the general market.

2. Swenson's formula is heavily laden with dividend-paying stocks, but he has also had high positions in natural resources, real estate and hedge funds, so his program is not easy for investors to imitate; Swenson has never had a down year, even in 2000–2003.

3. Investors can benefit from his concept of investing in a wide variety of dividend-paying stocks, and Skousen follows it in establishing seven categories of dividend paying stocks.

### High Dividend Picks

1. In the area of high-dividend-paying US stocks, funds and ETFs, Skousen favors good quality financial stocks such as Bank of America (BAC; yielding 7%).

2. Despite the housing fiasco, BAC is expanding aggressively; it is a

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core holding of Warren Buffett and is held also by contrarian Richard Dreman.

3. WisdomTree's group of ETFs, run by Jeremy Siegel and Michael Steinhart, are picks for high-dividend-paying stocks and funds; WisdomTree's International Top 100 Dividend Fund (DOO) has continued to do very well since its recommendation by Skousen in July 2007.

### Rising Dividends and Dividend Originators

1. Ned Davis Research shows that since 1972, companies that fall into a combination of rising dividends and dividend originators have done best in terms of dividends vs. non-dividends.

2. A favorite in that combined sector is China Medical (CMED), a foreign stock that just began paying dividends in 2007; its dividend has already risen from \$30 to \$42; its earnings and revenues are growing rapidly—the company is a biotech actually making money.

3. Already up 85% since July 2007, CMED has much greater potential—it could be a \$100 stock in 2–3 years [more than a double]; the stock is likely to be volatile and to drop with a decline of the Chinese stock market.

4. A mutual fund pick for the rising dividend category is Morningstar's Dividend Leaders Index Fund (FDL), Skousen's favorite ETF; FDL looks for above average growth potential and pays a reasonably high dividend around 3.6%.

### Business and Industry Dividend Stocks

1. For the fourth category of high-yielding Dow stocks, Skousen picks some of the dogs of the Dow such as AT&T (ATT), General Motors (GM) and Pfizer (PFE).

2. In category five, business development companies, Skousen finds opportunity in companies that have come down 20% because they are related to the financial markets.

3. Prime choices are American Capital Strategies Fund (ACAS; yielding 10.8%), a good play on venture capital firms, and Gladstone Capital (GLAD), the most conservative of the business development companies but still yielding 9%.

4. In the sixth category, real estate investment trusts, Skousen recommends equity REITS such as General Growth Properties (GGP; yielding 3%–4%), which is focused on shopping malls; among mortgage REITs, Countrywide (CFC) might be a good contrarian play with money one can afford to lose.

### Energy and Commodity Picks

1. Plays for the seventh category, energy and commodities, include the Canadian oil and gas trusts such as Penn West (PWE; yielding 15%); these are off 15%–20%; be warned that part of their high yield is actually return of capital; Arab interest in buying Canadian oil and gas trusts may generate a pop in price.

2. Three high-income commodity plays are FreeportMcMoran (FCX), Aluminum Corporation of China (ACH) and Southern Copper (PCU; yielding 8%).

3. PCU (up 30%) and ACH (100%) were Skousen picks in July; volatility triggered a stop for ACH, but it is a buy again around 56; ACH is also a favorite of Jim Rogers as a China play.

### US Global Investors

1. US Global Investors (GROW), another Skousen pick in July 2007, illustrates why using stop orders is particularly important with volatile stocks; GROW is down 45% since then, but Skousen was stopped out;

GROW is a buy again around 15.

2. The US Global Resources Fund (PSPFX) is up 20% since July and is still a recommendation in *Forecasts & Strategies*.

### Pluses for US Investing vs. China & India

1. Skousen has long been an advocate of foreign investing, but he points out that everything goes in cycles, and the growth in foreign markets has been a story for years; foreign growth may be built into the current price structure—all stock prices are forward looking.

2. The fact that growth in US productivity was recently announced to be 6% year over year is a plus for investing in the US.

3. Another positive factor is that the Pension Reform Act of 2006 strongly encourages US workers to invest in their 401(k) plans—this behavior should dramatically increase the savings rate and investing.

4. The USD is not likely to remain at all-time lows; Skousen expects a rally in the dollar.

5. Persisting with foreign investment can be likened to being in the growth trap; though China still looks good long term, it seems to be in a bubble blowoff at present—keep some money invested in foreign markets, but use protective stop orders.

6. Money growth in emerging markets such as China, India, Brazil and Russia has been high; in Austrian economics, such growth is not sustainable—asset bubbles eventually collapse; be alert to that and the fact that the US economy might surprise people.

### A Word to the Wise

Investors should keep themselves educated about what is going on in the world in order to be wise overseers of their managed money; they need to think for themselves, not just automatically follow someone else's advice.

Members may subscribe to Mark Skousen's free e-letter at [www.worldlyphilosophers.com](http://www.worldlyphilosophers.com). Complete contact information for his *Forecasts & Strategies* newsletter appears in your printed synopsis. His new book is available at major bookstores and online.

### SNEAK PREVIEW OF THE 2008 LINE-UP

- First-time IH guest Burt Malkiel wrote a previous million-copy bestseller, *A Random Walk Down Wall Street*. His new book is *Wall Street to the Great Wall: How Investors Can Profit from China's Booming Economy*.
- IH member Lon Morton and guest Angela Raitzin will introduce a conservative, innovative product that allows structuring an investment for a particular outlook and risk tolerance.
- Another appearance will be made by natural resources specialist Frank Holmes.
- The ever-optimistic Paul Merriman will be counterbalanced by a new guest from Hong Kong, well-known financial seer Marc Faber.
- Plus there will be a few other surprises and Joe Bradley's empowering synthesis of 32 years' of wisdom gleaned from his interviews as an investor's advocate.

*Stay tuned to Investor's HOTLINE for  
some of the best moments ever.*

Next issues release date: Friday, January 18, 2008