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# Investor's HOTLINE

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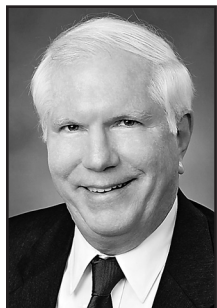
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March 2007

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

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## Forenotes from JOE BRADLEY

### March Guests

**1. Rick Maybury**, Middle East specialist and publisher of *U.S. & World Early Warning Report*, returns to update us on his unsettling analysis and forecast for that region, which he calls "Chaostan;" Rick offers an investment strategy appropriate for his outlook.

**2. Richard Lehmann**, president of Income Securities Advisors, is a top specialist on closed-end funds with an emphasis on income investing; he presents a concise, practical approach to using closed-end funds, munis, indexes and mutual funds.

3. Thanks go to IH members Moo Thorpe of Dougherty Real Estate Company in Santa Fe, NM, and Dave Rushmore of Benefit Plan Coordinators in Santa Ana, CA, for requesting this month's guests, respectively.

4. Release date is Friday, 2/16/07; the interviews were completed the previous week.

### Proactive Alternatives Against Terrorism

1. Brigitte Gabriel [AmericanCongressforTruth.com] is a vocal advocate of taking strong action against Islamic terrorists; she has appeared in documentaries such as *Obsession: Radical Islam's War Against the West* [ObsessionTheMovie.com].

2. Gabriel believes that political correctness is a terminal disease, and that the US reluctance to profile is an important part of this wrong attitude; she warns that there is no middle ground with extremists who are committed to annihilation of the West.

3. Australia is taking a more confrontational stance than the US; Prime Minister John Howard has reaffirmed his country's cultural identity and made it clear that his government is cracking down on Muslim extremists; disgruntled immigrants of any persuasion are encouraged to leave Australia.

### Strategy for Investing in Mutual Funds

1. Frequent IH guest Mark Sellers says that few mutual fund investors

beat the market long term by chasing past performance; keys to success are: (1) putting money with managers whose strategy you agree with; (2) caring more about the manager than the company offering the fund; (3) adding to your investment when a good manager hits a slump.

2. Here are steps to force yourself into a contrarian strategy: step one is to find the best managers—there are about 30 great mutual fund managers and about 200 good ones; step two is to divide a portion of your portfolio among a few of these above-average managers and put the rest of your equity allocation in index funds temporarily.

3. The third critical step is to follow each manager's quarterly returns and in quarters when the manager underperforms his benchmark, move index fund money into the actively managed fund; the worse a manager underperforms, the more you should increase your bet with him or her, and the more you should decrease your bet on the index fund.

4. Accordingly, Mark Sellers says that now is a good time to put some money with Bill Miller [Legg Mason Value Trust], who for the first time in 15 years has underperformed the S&P; Bill is slated for an upcoming appearance on IH.

### More Insights from Past and Future Guests

1. Louis Navellier, who will be re-appearing on IH soon, notes that bargain US stocks can be found, but more opportunities are available in other markets where earnings are accelerating and P/E ratios are improving; these are not good times, and the all-eggs-in-one-basket approach looks hazardous for 2007.

2. Dr. Roger Selbert takes exception to the dire, long-term view of Harry Dent—both are on the IH roster as demographic trend specialists.

3. Harry said on IH that he foresees boom years until 2010 in the DOW (40,000) and Nasdaq (20,000) underpinned by high points in demographic and technological cycles; then he expects a long bust from 2010 to 2025; Dent acknowledges opposing forces that may disrupt his predictions, but still sees no way to avoid stock and real estate market crashes.

4. Roger, however, points out that Harry has not factored in recent Census Bureau projections for total US population growth from 300 million today to 400 million by 2043; this growth of 2.7 million people a year means a continuing high demand for new and existing residential, commercial and industrial structures.

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## RICHARD MAYBURY

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### Maybury's Background

1. On *Investor's HOTLINE* after 9/11/01, Maybury predicted that the US would go to war with Iraq, that the public would become frustrated, and that the US would pull out.

2. In 1990 at the time that the Soviet Union was breaking up, he launched the first issue of his newsletter, *U.S. & World Early Warning Report*; people were cheering a new era of peace, but Maybury was taking a contrary view.

### Preliminary Perspective

1. The world periodically goes through very nasty situations; examples of past catastrophic events are World War I, World War II, the Great Depression and the Black Plague.

2. These terrible events do not hurt everybody; there are always people who survive, and some who prosper—sometimes from luck, and sometimes from knowing about the subject and being prepared.

3. Maybury's newsletter aims to put people into that fortunate group that will not be hurt; the publication keeps people informed and prepared to

make good decisions for themselves personally; Maybury's subscribers have done well so far by being cynical about conventional wisdom.

## General Analysis of the Middle East

1. The war will continue to metastasize into the Persian Gulf area containing 65% of the world's oil supply; there is no way to stop it from igniting the entire Gulf region.

2. Washington's enemies will not let the US get out, even if the US wants to exit; if US withdrawal appears likely, Maybury expects that they will strike the US again with something like 9/11 or worse to rekindle America's war fever; staying in will make the war worse, but that is what the enemy wants.

3. The analysis of Richard Clarke, the Cato Institute and others, that sending more troops is a mistake, is right—the correct action is to get out as rapidly as possible; Cato sees terrorism as a response to foreign occupation; Harry Browne believed that US meddling in the affairs of foreign countries, though usually well-intentioned, generated hatred.

4. The situation is complicated by the fact that there is no clear opinion of America shared by a majority of people in the Middle East; there are thousands of differing opinions and probably thousands of groups with different agendas.

## Historical Background to Islamic Attitudes

1. A central, influential group within Islam is out of patience with the West meddling in the Islamic world; this war is their way to make sure that when the West leaves, it will vow NEVER to go back, no matter what; this group may feel that they have not yet inflicted enough pain on the West to insure that deep resolution.

2. Americans think in terms of weeks, months and years; Muslims think in terms of decades and centuries because their civilization is so much older than ours.

3. The final Muslim invasion of Europe ended at Vienna in 1683; since then there have been few five-year periods in which Christian European troops have not been under arms on Muslim soil; the US has been allied with the Europeans for more than 200 years.

4. Many Muslims are sick to death of this pattern; they know that the West is still a long way from being willing to leave for good, so they plan to continue this war by whatever means they can.

5. Groups within Islam are willing to compromise and get along with America and the rest of the West; some groups within Islam are even strongly pro-American and wish that the US would take over in the Middle East and spread democracy.

6. Generally, the wish that Western governments would stop meddling in their countries seems to be a point of consensus.

## The Roots of Terrorism

1. Though there is no hard proof that it exists, Maybury believes that there is one group with roots in the Middle Ages that was behind 9/11; this covert group of professional terrorists has deep cover, good financing and centuries of experience fighting the Europeans.

2. That group has been working toward the present-day situation ever since the US started meddling in the Middle East in 1943, when Roosevelt took sides with the Saudis against their enemies.

3. Groups like al-Qaeda, the Muslim Brotherhood and Hezbollah are the "gofers" for this ancient group.

4. In support of his opinion, Maybury points out that covert warfare was invented in the Islamic world around the year 1300 in northern Iran as an alternative strategy to pitting masses of troops against troops; using a covert strike force to infiltrate the enemy and kill its leaders was more efficient.

5. The highly sophisticated moves by the enemy in the Middle East over the last 6–7 years suggest that this group still exists and is the mastermind behind these events.

## The American Embassy in Iraq

1. The American embassy in Iraq has become the largest US embassy in the world, far exceeding the size of the embassy in Moscow; the Baghdad embassy is its own walled, self-sufficient town consisting of dozens of high-rise buildings.

2. It is an emblem that Washington expects to be in this war forever.

## The Persian Factor

1. To understand Iran, it is important to recognize that the country is ancient Persia—owner of the Persian Gulf for more than 25 centuries—until Britain and the US took it away in the 20<sup>th</sup> century; it is rightfully Iranian territory, and Iran wants it back.

2. When war is finally over—no matter how long it lasts—the US will not be in the Persian Gulf, but Iran will be.

## Domestic Nuclear Risk

1. Before Alexander Lebed was killed, he claimed that more than 100 Russian suitcase nukes were missing; there are reports that such bombs are in Middle Eastern countries; the odds are high (probably 99%) that one will go off in an American city in the next ten years.

2. A suitcase bomb is a tactical nuke of no more than 1–2 kilotons of power; there are much larger nukes in existence (100–250 kilotons to 20 megatons), but these are well secured.

3. Should a suitcase bomb go off in a city, the damage would be limited in area to about a square mile; there are only five American cities that should be considered prime targets for such an attack: Washington, DC; New York; Chicago; San Francisco and Los Angeles.

4. The center square mile of those five cities is a very high-risk place, but outside those areas, risk drops to near zero; potentially, hundreds of thousands of people could be killed in a blast, but the rest of the population would be okay.

5. People should not panic; fallout does not drop instantly, so there would be time to evacuate—the direction to go is at a right angle to the wind and then upwind.

## Defending Ourselves at Home

1. There are fanatics among the enemy, as there are in any war, but there are also millions of people around them with whom we can compromise.

2. Adding police state measures to American life in an attempt to catch these fanatics allows them to win; draconian restrictions destroy the country that the fanatics are trying to destroy.

3. The public must understand that we are in a war and be willing to think and act accordingly—i.e., defending an airplane if necessary; the idea that we can be made safe by being made helpless is insane; the idea of the militia as described in the Second Amendment should be revived.

4. The obvious and impossible solution is for Washington to announce that it is withdrawing from the Islamic world permanently, and totally do so; if that degree of capitulation occurred, it may be possible that the other side would accept an end to hostility.

## Practical Investment Advice

1. The rule of thumb for investors is to buy things that will do well in wartime, such as the large US weapons-makers, General Dynamics (GD), Lockheed (LMT), Raytheon (RTN) and Northrup Grumman (NOC)—avoid Boeing because of its exposure to the civilian airline industry; Fidelity Select Defense & Aerospace Fund (FSDAX) offers a good collection of weapons companies.

- Raw materials tend to go up in wartime; BHP Billiton (BHP) is one of the world's great producers of raw materials.
- Be careful in selecting oil stocks; avoid any that have fixed assets in Eastern Europe, Asia and North Africa; oil drillers and service companies have assets in those risky parts of the world, but they can remove assets when warranted; Schlumberger (SLB) is the #1 pick in this area; Fidelity Select Energy Service Fund (FSEX) offers a basket of them.
- Gold and silver have only just begun their rise because the war is in its early stage; everyone should have at least 5% in gold and silver bullion coins.
- Harry Browne's conservative, all-weather investment allocation was described in his book *Failsafe Investing* and implemented in his Permanent Portfolio Fund (PRPFX); overall the fund has returned 8%–10% since the late 1970s, and 13.58% annualized for the last 5 years since the start of the war; designed for safety, it is the closest thing to a bulletproof investment plan.
- Two good speculative stocks are Suncor (SU) and Sasol, Ltd. (SSL), which should do well as the war spreads; at some point oil will spike in

a panic to \$300/barrel, and gasoline to \$9/gallon—then alternatives will come into the market, and oil will fall way back.

- Except for PRPFX, the other recommendations are all speculative; the one with the least downside would be FSDAX.

### Summary Advice

- Maintain the perspective that people have survived worse disasters (including World War II) than what faces the US now; even though there will be a prolonged period of pain ahead, individuals can be happy and comfortable.
- Focus on taking care of yourself and your family, and keep yourself well informed—try to understand the enemy's way of thinking so that you are not caught by surprise.
- If you make investments that will do well in wartime, you can even prosper.

*Investor's HOTLINE* members may subscribe to Rick Maybury's newsletter, *U.S. & World Early Warning Report* (reg. \$300) at a 50% discount. Use the contact information at the top of the interview to place your order.

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### Economic Analysis from a Global Perspective

- The fact that the economy is doing quite well is puzzling because according to precedent, it should be tanking; the housing crisis, upward spike in interest rates and negative yield curve should be having adverse effects.
- The explanation must be that the imbalance in world trade has created a tremendous cash glut; most of that cash is coming to the US to be invested; rather than leading the other economies of the world, the US is more integrated with them.
- In the past, the influx of foreign money roughly equaled the budget deficit and was absorbed by the government; now the trade imbalance exceeds the budget deficit, so there is a spillover effect into the rest of the economy.
- The excess foreign governments have is not a matter of central banks creating too much money but rather of there being no market but the US big enough to absorb the excess; until China, for example, decides that it wants to buy goods, there is no place to invest except the US.
- The unique status of the US economy is a protective factor for the US against the money suddenly being redirected.

- Lehmann agrees with the opinion that investors are taking much more risk for income investments than in the past; there is a shortage of investment-grade debt, so people are reaching lower for yield.

- Eventually there will be a shakeout in bonds; in the default process, companies are constantly deteriorating, but banks keep funding them until the residual value declines to the level of what is owed—often at the onset of recession.

### Prospects for Recession and Real Estate

- Because the day of reckoning with debt default has been postponed for so long, it will be worse than it would have been earlier; that will draw out an impending recession because bank credit will be tightened up for a longer time.
- Timing is always a problem—the astute recognize potential trouble long before it comes to pass and risk missing a lot of upside; especially now, conditions represent uncharted waters, so predicting when events will turn is unreliable.
- Gary Shilling's doom-and-gloom outlook for real estate makes perfect sense in terms of the past, but the amount of liquidity in the market this time is a new dynamic that allows banks to extend mortgage holders rather than foreclose.

### Approach to Income Investing

- Lehmann encourages the diversification of sources of income; the bond market has become so institutionalized that bonds are no longer a good instrument for individuals—private investors should look for different drivers of income.
- Interest rates are the traditional key driver for income, but other areas for an income source include the stock market and energy; Lehmann recommends 40% in income-sensitive securities and another 20% in

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stock-market-sensitive securities (convertible preferred stocks and convertible bonds).

3. As conditions vary, the diverse components of the portfolio will rise and fall relative to one another; the convertibles have a capital gains component that bonds lack.

4. Energy trusts (for another 20%) are also excellent sources of income—especially with energy looking like it will stay high; even at \$50 oil, energy trusts yield tremendous returns.

5. If oil drops to \$40, the trusts would cut dividends, but \$40 oil would stimulate the stock market and cause convertibles to rise.

6. Canadian energy trusts are yielding nearly 20% because of the drop in oil and the decision by the Canadian government (which may change) to tax the trusts in four years (which would be workable for the trusts in any case).

7. Another portfolio component (20%) is in company- and industry-specific events or special situations; the essential driver for these is the media, who have hyped the decline of Ford and GM; they remain firm companies that will survive—Ford preferred stock (yielding 8% and convertible for 20+ years) is still a favorite of Lehmann.

### Types of Funds for Income Investing

1. Closed-end funds can get a better return than individuals; these funds aggregate investments (bonds, preferred issues, convertibles) that individuals cannot buy; funds do better analysis than individuals, and they can leverage their balance sheets.

2. ETFs are the safest way to invest in many foreign markets; stories of stock manipulation and stock fraud are common in Asian countries, for example, so it is not prudent for individuals to invest there; ETF fees are lower than for closed-end and mutual funds in foreign markets.

3. Open-end mutual funds offer the performance of a particular manager; sometimes there is a divergence of interest between what is best for the manager's reputation and what is best for fund holders, particularly for risk-averse income investors.

4. Under a positive yield curve, interest-rate-sensitive closed-end funds can use leverage to get a better rate of return.

### The Outlook for Interest Rates and the USD

1. The secular trend in interest rates since 1982 has been down, but there is still some room on the downside; yields after inflation can go as low as 2%—with 10-year Treasuries at 4.7% and inflation around 2%, a drop of another 70 basis points is conceivable.

2. Even if that drop occurred, the dynamic of foreign money coming into the US would prevent a Japanese-style deflation; the strength of the USD boosts foreigners' profit beyond the interest rate through currency appreciation.

3. A strong dollar is in the US's best interest because the requirements of the domestic financial industry are larger and more important than the export industry.

### Tax-free Munis

1. A closed-end structure makes sense for municipal bond funds so that trading does not have to accommodate liquidations and new funds coming in.

2. Munis are not used in portfolios by Lehmann at all; he sets aside tax considerations with one exception—breaking out the qualified dividend income (QDI) for preferred shares.

3. Preferred shares are an alternative to municipal bonds that are taxed at only 15%; because their yield is so much higher, their after-tax performance is 1%–2% better than munis.

4. Investors who are in a position to use munis should buy AAA insured munis directly to avoid the risk of any loss; the higher yield that may be generated by a muni fund manager is offset by fund fees and the higher risk.

### Recommendations

1. Good closed-end funds in the interest-rate-sensitive category include Flarerty & Crumrine/Claymore Preferred Securities Income Fund (FFC, yielding 7.2%) and John Hancock Tax-Advantage Dividend Income Fund (HTD, yielding 5.7%—most of which is qualified dividend income); for higher yield with greater risk, consider Neuberger Berman Income Opportunity Fund (NOX, 12.8%).

2. The entire preferred market is less sensitive to interest rate swings than the bond market, which is very large and institutional; most holders of preferred securities are individuals who do not make sudden, massive changes in their portfolios.

3. Even NOX would not be as reactive as bonds, but it and other funds that hold more low investment-grade securities would be hit early when defaults pick up.

4. In the stock-market-sensitive area (20% allocation), closed-end convertible funds worth considering are Advent Claymore Convertible Securities & Income Fund (AVK, 9.1%) and Nicholas-Applegate Convertible & Income Fund II (NCZ, almost 9%); these funds will do well if the stock market is strong.

5. For the energy portion of the portfolio, the Canadian trusts are the highest yielding, but they are subject to 15% withholding tax, so hold them in a taxable account to benefit from the tax credit.

6. For tax deferred accounts, consider the BP Prudhoe Bay Royalty Trust (BPT) in Alaska, which yields 8.7% and avoids the Canadian withholding.

7. The two strongest Canadian oil and gas trusts both have deep reserves—Enerplus Resources Fund (ERF, yielding 10%) and Penn West Energy Trust (PWE, yielding 11.5%); Harvest Energy Trust (HTE, 17.5%) and Canetic Resources Trust (CNE, 17%) offer higher yields, but they have less extensive reserves and are more vulnerable if the price of oil and gas drops below \$50.

8. The best special situations in the past 18 months have been General Motors (GM) and Ford (F), which were yielding as much as 14%; they have made a great comeback but are still returning 8%–9%—quite attractive in today's market; Lehmann expects capital appreciation of those securities in the coming year.

### Fallen Angels Income Fund (FAINX)

1. This new fund, for which Lehmann is the portfolio manager, will be modeled on the portfolio breakdown discussed in the interview with the aim of balancing the several income sources to provide security against any single negative event in the economy.

2. Within weeks, FAINX will appear at Morningstar, Yahoo! and other sources; find information already by searching the Web for the name; a prospectus and instructions for ordering are available.

### Lehmann's Publications

1. Lehmann's new book, *Income Investing Today*, will come out in early May 2007; it elaborates on his philosophy in great detail with background and explanation of why this portfolio approach works better than some traditional strategies such as buy-and-hold and laddering.

2. Lehmann offers continuing portfolio advice at [www.incomesecurities.com](http://www.incomesecurities.com); the site contains history and current status on all the recommendations over the last ten years that are still current outstanding; at the site members can also sign up for a monthly newsletter.