MAULDIN ECONOMICS | YIELD SHARK

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The Cancer of Debt and Deficits – Profit Opportunities from Countries with Responsible Governments

by John Mauldin

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Welcome to the inaugural issue of Mauldin Economics' *Yield Shark*, in which my team and I will deliver unique, profitable investment-income ideas that can help you protect and grow your money, no matter what the market environment.

Yes, it's possible to do that, and you can do it even as the Debt Supercycle rolls toward the day of reckoning for all the countries that have borrowed their way into a financial corner.

But it requires good information and careful analysis. The hazards for careless investors are only going to increase in 2012, because this will be the year that the consequences of the reckless spending choices of so many of the world's governments begin to truly manifest themselves.

The closing chapters of the current Debt Supercycle find different countries strewn out along the path, some at more advanced stages than others, but all headed for a destination that will force painful political decisions.

One by one, the countries of Europe are losing their ability to borrow in the bond market at interest rates they can afford without making severe and socially disruptive spending cuts.

The US will soon be faced with that same problem. As bond investors look at Europe and a soon-to-implode Japan, they will decide that the US is different only in scale.

Last year, our growing national debt surpassed our country's GDP. Think about that: our big-spending politicians have borrowed so recklessly that we now owe more than the collective annual output of all individuals and businesses in the entire United States.

And our debt problem is going to get worse.

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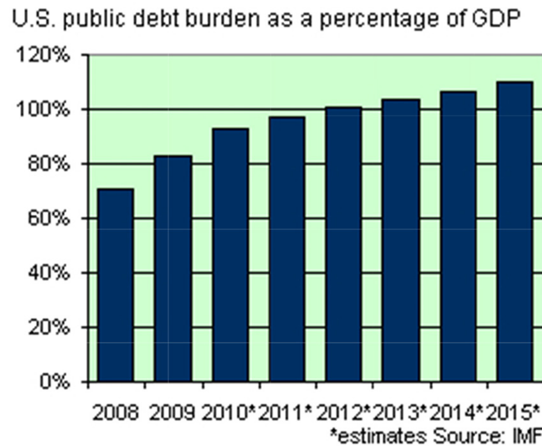


Source: Wall Street Journal

The interest on our $16 *trillion* of bond-financed national debt is consuming an ever bigger share of the government's overall budget. Any rise in interest rates will rapidly make that problem even worse and will force an ugly choice:

- Cut government spending drastically, even for programs that are necessary or widely popular; *or*
- Accept a painful increase in taxes; *or*
- Look the other way while the Federal Reserve creates still more new cash to monetize the debt – and sets off a whirlwind of price inflation.

None of those choices will have good outcomes.

Our ballooning deficit will soon invite the bond market to treat us just as it's treating Greece or Italy – or any other country that gets to the point where its debt is unsustainable.

No country can run deficits the size we are currently running, along with unfunded deficits over four times the size of the economy, without ruinous consequences.

At some not-too-distant point, investors in bonds will start to question the ability of the United States to service its debt and will begin treating our government debt like a red-headed stepchild.

Investing in a Low-Yield Universe

Today you have to go to bonds with maturities out beyond five years to get more than a 1% yield. Who is buying this stuff?

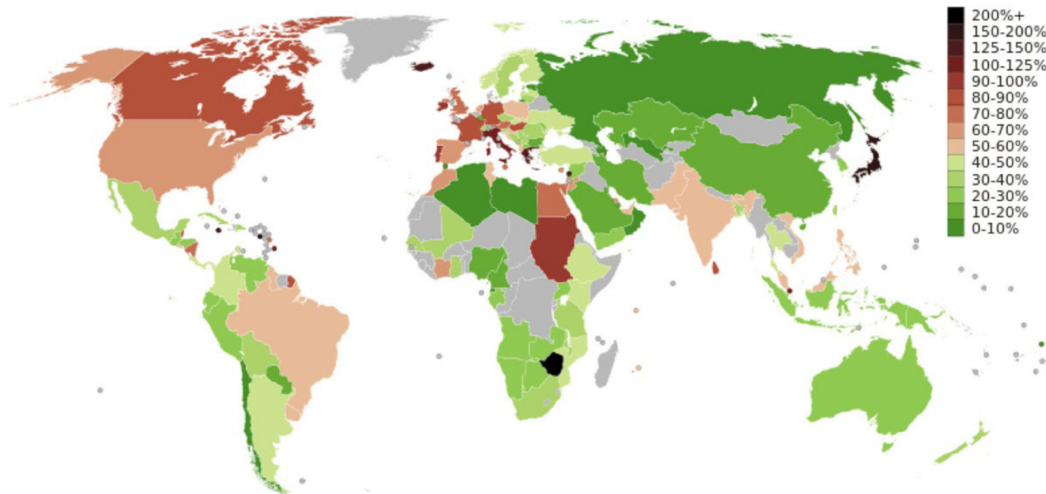
Ultra-low yields have changed the rules for successful income investing. That's why you need to discard your old investment habits and learn new ones.

It's been said that there is always a bull market somewhere.

If you go back to the 1970s, a period of loose monetary policy and excessive government borrowing, you find a long period of doldrums for US and European stock markets.

For example, $1 invested in US stocks in 1970 grew to only $2 by 1985. But over the same period, $1 invested in Japanese stocks would have grown to $6. And $1 invested in Hong Kong equities would have turned into more than $8.

Going forward, Asian, Latin American, and African markets will be the big winners from the loose monetary policies of governments around the world. Just as the easy-money attitude the Fed adopted after the bursting of the Internet bubble led to the US housing bubble, the Fed's money printing today is inflating emerging markets.



Source: CIA World Factbook

And there are pockets of opportunity even in Europe, primarily in Scandinavia and Eastern Europe, where responsible governments have stayed within their means and run budget and/or trade surpluses.

I spend a lot of time traveling around the world, and I have a Santa Claus list of the naughty and nice countries. The map above clearly distinguishes the (red and brown) spendthrift countries that deserve a lump of financial coal from the (green) countries that have behaved themselves.

Those are countries in which economies are expanding, people are plentiful, debt is under control, and corporate profits are growing. In short, those countries are incubators of better earnings, rising stock markets, and safe dividends – places that deserve your money.

The right foreign stocks offer a profitable kicker. Since their revenues and profits are earned in foreign currencies, you may collect an extra 5%, 10%, or more from the currency translation. A falling dollar can actually boost your profits on non-US investments.

These are the new realities of successful investing for income.

If you're worried that investing in foreign income stocks is difficult or expensive, don't be. The foreign opportunities we'll show you are traded on US stock exchanges – the NYSE, NASDAQ, or the over-the-counter market. In short, they are as easy to buy as shares of General Electric or Microsoft.

Our Three Roads to Income Independence:
High Income, Foreign Income, and Best of Both Worlds

No two investors are exactly the same. That's why we'll be covering three distinct types of income investments: High Current Income, International-Income, and Best-of-Both-Worlds ideas.

1. High Current Income: Everyone could use more income. No one can live on the paltry sub-1% yields that Treasury bills, money market funds, and CDs pay today.

We're turning over thousands of investment rocks to uncover a short list of reliable – and often unknown – income gems that pay out a handsome, steady stream of double-digit returns. Some pay quarterly, others pay monthly or even semiannually.

Capital appreciation is a secondary goal for many of them, but our focus is on high current income for wealth-building or retirement needs.

2. International Income: We know that our unsustainable $16 trillion debt bomb is going to explode and send the US dollar into the Debtors' Hall of Shame, along with Greece, Iceland (Iceland is the correct country), and Spain.

Your best defense against the inevitable dollar devaluation is to invest in foreign dividend superstars that send you non-dollar paychecks each quarter. Foreign stock markets are driven more by actual dividends, rather than by growth prospects; so they pay out, on average, 50% more than US stocks do.

Plus, foreign stocks pay dividends in their own currencies, which makes them more valuable to US shareholders when the dollar sinks. Not only do you get paid handsomely, you have the bonus kicker of currency appreciation as the US dollar falls.

3. Best of Both Worlds: The goal of this income-plus strategy is to allow your portfolio to grow and still yield substantial income. The income will come primarily from dividends and payments from specialty funds, ETFs, convertible securities, and special situations.

Dividends don't receive a lot of media attention because, well, they are boring. Good things do, however, come in small checks; and dividends deserve more of your attention, because they provide a steady and real cash return. Dividends are important because:

- **Lower risk.** Companies that pay out dividends hold up better during bear markets. In fact, when the market gets ugly, dividend-paying stocks become a magnet for investors seeking security.
- **Dividends don't lie.** Financial magicians can make a company's paper profits look better than they really are. Corporate magicians can cook their books, but cold hard cash can't be faked. Earnings are a story; cash is a fact.
- **Better yields with lower taxes.** Dividends are taxed at a 15% rate. Interest from savings, CD, bonds, or money markets is taxed at rates up to 35%.
- **Dividend stocks trump non-dividend payers, even in down markets.** According to Standard & Poor's, during 2008's market meltdown, dividend-paying stocks came out over 6% ahead of non-dividend payers.

The yields on the holdings in this portfolio will range from 4% to 8%. It's an excellent strategy for investors who want to get paid while they wait for capital appreciation. The best of both worlds!

Mix and Match!

It's up to you, but the best approach for most investors is to use a blend of all three strategies and allocate a portion of your capital – say, 10% to 70% – to each one.

Here are some guidelines to consider, depending upon your stage of life:

Saving for Retirement

20% High Current Income
30% International Income
50% Best of Both Worlds

Living Off Investment income

40% High Current Income
30% International Income
30% Best of Both Worlds

I recommend the first structure if you're just starting to save for retirement. As you get closer to retirement day, move toward the second structure.

Lastly, we'll indicate a specific number of shares or dollar amount for every recommendation we make, based upon a hypothetical portfolio valued at $100,000 and approximately $5,000 per position. You should adjust the share or dollar amounts to reflect the size of your portfolio.

The longer I'm in this business, the more I realize how much I still have to learn. Fortunately, I regularly get to pick the brains of the brightest investment minds in the world, and I've learned to pay careful attention to their best ideas.

For this inaugural issue of *Yield Shark*, my best-of-breed team of investment-income pros have come up with three income superstars that you should add to your portfolio today: a Best-of-Both-Worlds opportunity yielding 4%, an International Income fund yielding 5.5%, and an High Current Income real estate investment trust (REIT) that yields 13%.

Now here they are – meet the *Yield Shark* Investment Team!

International Income Opportunity
Add This Asian Income Superstar Today

$16 trillion... and counting. At some point in the not-too-distant future, the staggering amount of debt the US has accumulated will deliver painful consequences – higher taxes, deep spending cuts in popular entitlement programs, a recession, and a plunge in the value of the US dollar.

The problem for US investors is that most of our assets – stocks, bonds, real estate, and even our 401(k) plans – are tied to US currency. The typical American portfolio is vulnerable to a falling dollar.

That's why investing in non-dollar-denominated bonds of stable, growing, *responsible* countries is a smart move. For that purpose, **Aberdeen Asia-Pacific Income Fund (FAX)** is our #1 choice. It's a closed-end bond fund whose objective is to generate current income by investing at least 80% of its assets in Australian and Asian debt securities.

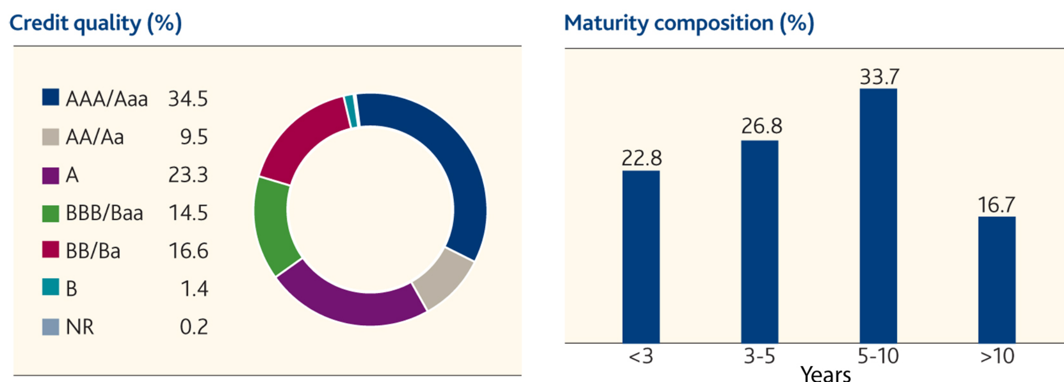
Aberdeen isn't a household name in the US, but in Asia it is a major investment house. Aberdeen Asset Management was founded in 1983, has offices in 23 countries, and manages $290 billion. Its Asia-Pacific Income Fund has been in operation since 1986 and is one of the most widely owned foreign income funds in the United States.

Roughly 46% of the fund's assets are in Australian bonds, which is a big positive, because the economies of resource-rich countries like Australia and Canada are healthy and growing.

The remainder of the fund is widely diversified across Asia, primarily in South Korea, Singapore, China, and Taiwan.

Short Maturity, Top Quality

The two biggest risk factors when investing in bonds are credit quality and time to maturity.



Source: Aberdeen Asia-Pacific Income Fund

Most of FAX's capital is in AAA government bonds. And roughly 50% of the fund's bonds mature in less than five years, while another 31% mature in under ten years. Avoiding 20-year and 30-year bonds lessens exposure to damage from rising interest rates.

Top ten holdings

As of March 31, 2012 the top ten holdings based on total assets were as follows:

Holding	Coupon/Maturity	(%)
Treasury Corporation of Victoria	5.75% 11/15/2016	5.7
Austrailia Government Bond	4.50% 10/21/2014	4.2
Austrailia Government Bond	5.75% 07/15/2022	3.5
Austrailia Government Bond	4.75% 11/15/2012	2.6
Austrailia Government Bond	5.50% 01/21/2018	2.4
Austrailia Government Bond	6.50% 05/15/2013	1.8
Queensland Treasury Corporation	6.00% 06/14/2021	1.4
St. George Bank ltd.	10.00% 05/09/2018	1.3
Queensland Treasury Corporation	6.25% 06/14/2019	1.2
India Government	7.02% 08/17/2016	1.2
Total		**25.3**

Source: Aberdeen Asia-Pacific Income Fund

Successful strategy that pays off. Aberdeen Asia-Pacific Income Fund has been around since 1986, and it has delivered an average annual return of 9.6% (as of the end of January 2012).

Market price	Cumulative	Annuatized
Since inception	955.7	9.6
Ten years	289.6	14.6
Five years	72.9	11.6
Three years	98.9	25.8
One year		20.0

Source: Aberdeen Asia-Pacific Income Fund

The Aberdeen Asia-Pacific Income Fund's most recent dividend of $0.035 was paid out at the end of June. The fund does pay monthly dividends, so the next dividend will be distributed near the end of July.

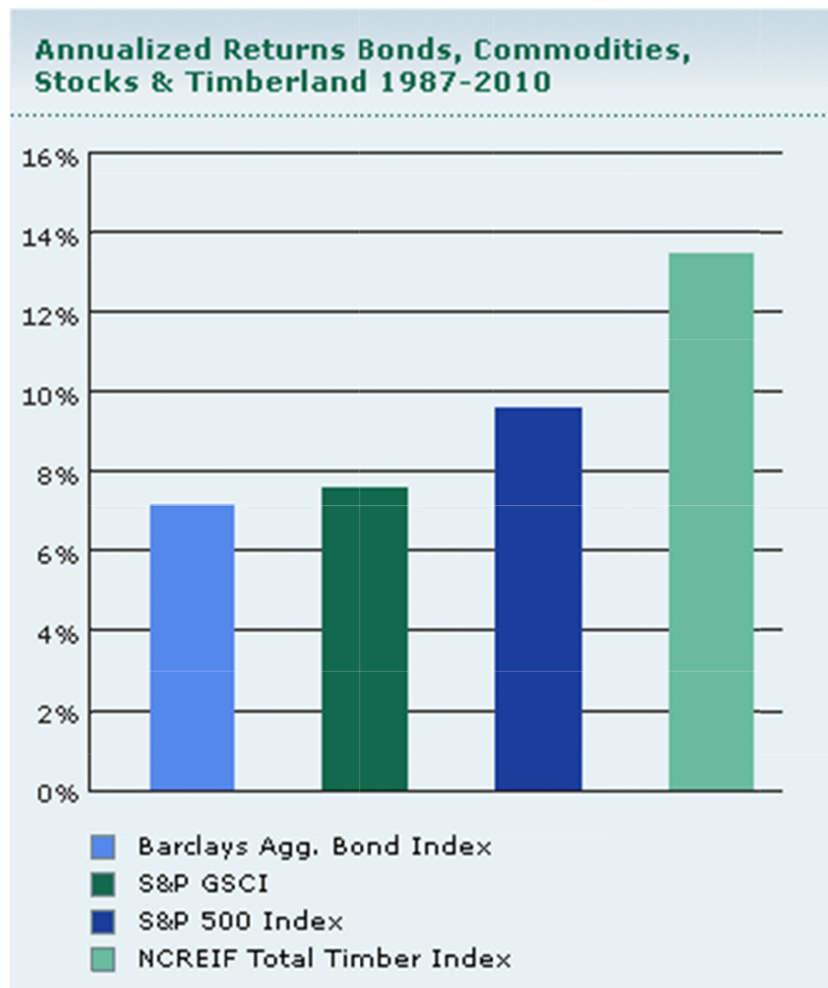
The fund is traded on the New York Stock Exchange and currently is changing hands near $7. Here's what to do:

Assuming a $100,000 portfolio, BUY 600 shares of Aberdeen Asia-Pacific Income Fund, symbol FAX, at the market. Place a protective stop loss at $6.85.

Best of Both Worlds
Money Really Does Grow on Trees!

Trees represent rich opportunities for investors who understand the dynamics of timber as an investment. Timberland is used as an investment primarily by large institutions such as pension and endowment funds. It is one of the most productive investments you've probably never considered. Here's what makes it so attractive:

Trees beat stocks. Timberland has actually delivered better returns than the stock market. Since 1987, the most commonly used index for timberland, the NCREIF Timberland Index, gained an average of 15% per year, compared to 11% for the S&P 500.



Source: The Campbell Group

Uncorrelated to stocks. Trees don't know about the debt crisis in Europe, our $16 trillion national debt, or even bear markets (though they may be acquainted with bears). Trees keep growing year after year and deliver some of their strongest returns when the stock market is struggling, so timberland is an excellent defensive hedge for your portfolio.

Through the 1970s, a tough decade for stock investors, timberland never had a losing year. Trees just keep growing, season after season.

- Timberland delivered positive returns in four out of the five most recent major bear markets. In 2008, when the S&P 500 lost 38%, timberland gained 9.5%.
- During the Great Depression, timber was up 233%, while the price of stocks fell more than 70%.

Timber beats inflation. Most investors think of gold as a hedge against inflation, but timberland, too, is an excellent hedge. Over the last century, timber prices have risen at 3.3% above the rate of inflation. During our last inflationary bout in 1973 to 1981, timberland delivered an average of 22% a year.

Flexible and safe. A unique feature of timberland is that it is both a factory and a warehouse. Timber can be grown and then stored on the stump, which gives investors the flexibility of harvesting trees when timber prices are up or postponing harvests when prices are down. And unlike oil, where new discoveries expand supply, there are no hidden timber deposits waiting to be discovered.

This may surprise you, but timberland is resistant to natural disasters. Fire and other disasters consume, on average, less than 0.5% of forests a year, so the risk is minimal. Even damaged timber retains much of its value. For example, 80% of the scorched trees from the Mount St. Helens eruption were still merchantable.

Time is your friend. Best of all, the longer you leave a tree in the ground, the more valuable it becomes. For example, a North American timber forest grows by about 8% a year, and a 24-year-old southern pine is worth three times as much as a 12-year-old tree.

The best vehicle we've found for investing in timber is **Plum Creek Timber**, a master limited partnership that owns vast timberlands in the United States, is a major lumber producer, and is becoming a very profitable real estate development company.

Plum Creek is the second-largest private timberland owner in the United States, with approximately 7.8 million acres in 19 states.

At a market cap of $6.1 billion, the market values Plum Creek's land at less than $800 an acre, which is peanuts, and assigns *zero* value to the company's vast timber holdings.

Even though Plum Creek owns some extremely valuable real estate, its basic business is selling timber, so its annual profits will move up or down with timber prices.

The future for timber prices is bright, largely because of the booming Chinese demand for lumber. In 2011, China became the world's largest importer of logs and lumber. China purchased 46% of all logs exported from the US last year and is expected to keep buying more and more.

As a plus, Plum Creek's timberland includes some of the most scenic property you will ever see; it's in high demand from developers and gentleman ranchers. When and where it's appropriate, Plum Creek is rezoning, developing, and selling off its non-core acreage for huge profits.

For example, Plum Creek pulled in over $300 million in real estate sales in 2011, roughly 25% of total revenue. In the first quarter of this year, the Real Estate Division generated $100 million of sales, and the company expects to match its 2011 sales this year.

Lastly, Plum Creek also owns valuable mineral assets underneath its trees. Example: PCL leased 64,000 acres in Louisiana for shale oil exploration, for an upfront payment of $21 million. There will be even more if the exploration finds the oil that is expected.

Plum Creek's most recent dividend of $0.42 cents was paid out on May 16, 2012. That means the next dividend will be distributed around the middle of August.

Plum Creek Timber has been trading under $40 since early May and pays out $1.68 per year in dividends, for roughly a 4% yield. Combine that with the fantastic long-term, steady growth from timber and you get a truly "best of both worlds" investment opportunity. Here's what you should do:

Assuming a $100,000 portfolio, BUY 100 shares of Plum Creek Timber, symbol PCL, at the market. Place a protective stop loss at $31.

Double-Digit Income Portfolio
13% on This Bond Fund in Disguise

It isn't easy to find an investment that pays out a double-digit yield safely, but we've found one, and you're going to love it.

Annaly Capital Management (NLY) is a mortgage real estate investment trust (REIT). It pays out a 14% dividend that we believe is rock-solid until at least until 2014. Here are the details.

NLY has a very simple and effective business model: it makes money by borrowing short-term at close to zero cost and invests the cash in government-sponsored, mortgage-backed securities from Freddie Mac, Fannie Mae, and Ginnie Mae.

There are basically just two moving parts to this successful business model: (1) keep borrowing costs as low as possible and (2) maximize the return on the borrowed capital. The profit margin is the difference between the two.

As long as the yield curve remains positive – long-term rates substantially higher than short-term rates – Annaly should be able to make a lot of money and pay out a lot of dividends… to *you*.

Ben Bernanke all but guaranteed that until the end of 2014. "*The Committee expects to maintain a highly accommodative stance for monetary policy. Economic conditions – including low rates of resource utilization and a subdued outlook for inflation over the medium run – are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.*"

Annaly Capital Management currently pays annual dividends of $2.20 per share, which at its recent $17 stock price translates into a dividend yield just under 13%.

That's not an aberration. Annaly has been paying solid dividends to its shareholders since it was founded in 1997. Here's the history.

Year	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Price	$16	$19	$20	$20	$12	$14	$19	$15	$16	$17
% Chg.	5.7%	2.9%	2.0%	-7.0%	2.6%	6.0%	-2.0%	3.5%	3.7%	1.9%
Dividend	$2.67	$1.95	$1.98	$1.04	$0.57	$1.04	$2.08	$2.54	$2.65	$2.44
Total Return	**35%**	**15%**	**10%**	**-35%**	**21%**	**4%**	**-10%**	**24%**	**23%**	**11%**

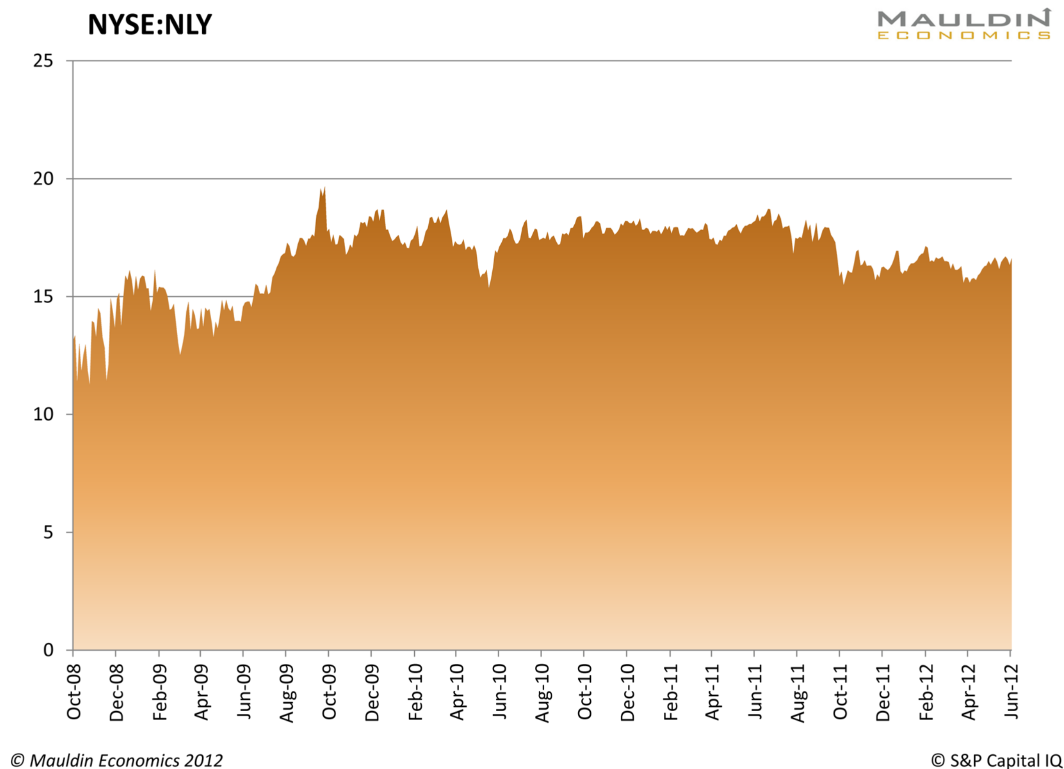
Annaly is one of the few companies that paid out hefty dividends during the 2008 downturn. The only year Annaly gave investors an upset stomach was in 2005,when the dividend was cut in half.

Of course, a dividend is only one component of total return. The other is the performance of the stock, and in that regard Annaly Capital Management looks even better.

For the last five years, the stock price increased by 6.6%, plus another $7.70 in dividends. By comparison, the S&P 500 was down 2% during the same period.

From a rolling five-year standpoint, the worst period (2002 to 2006) gave an average annual total return of about 9%.

The highest five-year rolling-average return was 30%!



What could go wrong with this double-digit money machine? The biggest risk to Annaly is rising short-term interest rates; but as I mentioned above, Bernanke and his Fed buddies have pledged to maintain their near-zero interest rate policy at least until the end of 2014, so the dividend looks rock-solid for at least another two years.

Here's what to do:

> **Assuming a $100,000 portfolio, BUY 400 shares of Annaly Capital Management, symbol NLY, at the market. Place a protective stop to sell ALL your shares at $12.80.**

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