POISON

in Your Portfolio

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Poison in Your Portfolio

Your Step-by-Step Guide to Safety and Profits

Martin D. Weiss, Ph.D., and Mike Larson

The U.S. economy is in a recession, and anyone who still believes otherwise must be living on another planet. This means that many stocks in your portfolio, once representing red meat and hot spice, could now be turning to poison.

We have irrefutable proof of a credit crunch. And we know that, in a debt-addicted economy like ours, the tightening of credit is bound to cause some severe withdrawal pains.

Most important, we now see every major force we've been warning about converging in one time and place:

1. The home market crash we first warned about in our* Safe Money Report *of February 2005 is here.

2. Derivatives — the "global Vesuvius of debts and bets" — that we wrote about in our* Safe Money Report *of November 2006 is beginning to erupt.

3. The recession we forecast in our* Safe Money *of September 2007 is here.

4. We also said the Fed would fight back, and do so aggressively, fomenting an inflationary recession. Sure enough, the Fed has cut interest rates all the way to 0-0.25%. Plus, it is pumping in massive amounts of money, trying to calm markets and seeking to avert a recession. But it's too little, too late for the economy. And it could be too much, too soon for the already-shaky U.S. dollar.

Our urgent appeal: If you haven't done so already based on our earlier warnings, the time is *now* to shift from complacency to protective action ... from bull-market plays to income opportunities ... from risk to safety.

Here are the specific threats we see to each category of assets that many investors still own, plus the steps we recommend for each.

Important: The stocks, ETFs and mutual funds we recommend selling below are strictly the most prominent among many. You should also look to sell every other one in their category.

Bank and Brokerage Stocks: Don't Count on the Fed's Rescue Efforts to Boost Their Profits

The Fed's money pumping actions won't stop the massive loan losses already in the pipeline. Nor can they stop home values from falling ... homeowners from foreclosing ... builders from defaulting on construction loans ... business and consumer loans from going bad ... and more red ink from flowing to the banks' P&Ls.

Your steps:

Step 1. If you own major bank and brokerage stocks, use any Fed-inspired rally to sell.

Step 2. ETFs and mutual funds are diversified. But if they own mostly stocks that are vulnerable to this crisis, that diversification alone won't protect you. Sell ETFs like the **Regional Bank HOLDRs Trust (RKH)** or **Financial Select Sector SPDR Fund (XLF)**, as well as mutual funds like **Fidelity Select Home Finance (FSVLX)** or **AIM Financial Services Fund (FSFSX)**.

Step 3. If, for some reason, you cannot sell, consider buying some protection with an ETF that's designed to *go up in value* when the sector

goes down. For the first time in history, these special ETFs give average investors the opportunity to gain the kind of protection they need in a falling market.

They are called *inverse ETFs,* and for the protection (or profit) from the financial industry, the ETF to use is the **UltraShort Financials ProShares (SKF)**.

Note: Since our *Safe Money* Model Portfolio does not have any exposure to financial stocks, it does not include this inverse ETF. But if you are exposed, you may need this hedge.

Retail Stores and Chains: Credit Crunch Driving Away Consumers

Ours is a debt-addicted society. Without abundant new debt (credit), millions of consumers automatically lose their spending power. And right now, according to the Federal Reserve's latest survey ...

- The percentage of lenders tightening standards on credit card loans has jumped to the highest since 2003 ...
- More banks are making it harder to get consumer loans than any time since at least 1996, and ...
- More banks are tightening standards on *prime* mortgages than ever recorded.

Result: Consumers are suffering severe withdrawal pains — and their only choice is to cut back their spending.

Your steps:

Step 1. Use any Fed-inspired rally to sell retail stocks, and don't let past gains or recent losses dissuade you from taking swift action:

- Sell **Target (TGT)**
- Sell **Williams-Sonoma (WSM)**
- Sell **Bed Bath & Beyond (BBBY)**
- Sell **eBay (EBAY)**
- Sell **Amazon.com (AMZN)**

Step 2. Also sell any ETFs or mutual funds you may be holding in the retail sector. That includes **Retail HOLDRs Trust (RTH)**, **SPDR S&P Retail ETF (XRT)**, plus **Rydex Retailing Inv (RYRIX)** and **Fidelity Select Retailing (FSRPX)**.

Step 3. If you cannot sell, consider buying some protection with an inverse ETF tied to this sector, such as **UltraShort Consumer Services ProShares (SCC)**.

Tech Stocks: The Next Domino to Fall

In late 2007, many Wall Street analysts were saying that tech stocks were a "safe haven." Since they don't write mortgages, the theory was that they were the place to run to during the mortgage crisis.

We couldn't believe our ears! And the dump that tech stocks suffered in the first days of 2008 underscored our belief that this was the next domino to fall.

That's why we've recommended the **UltraShort Technology ProShares (REW)**, designed to deliver 20% gains for each 10% decline in the Dow Jones U.S. Technology Index. (See our Model Portfolio in your regular issues of *Safe Money Report*.)

Your steps:

Step 1. If you happen to own any, sell semiconductors.

Step 2. While you're selling, be sure *not* to exclude industry leaders, even if they've *already* been hit hard. For instance, use any rallies to sell **Micron Technology (MU)** and **Advanced Micro Devices (AMD)**.

Step 3. Also use any rallies to dump ...

- Cell phone and electronic gadget maker **Motorola (MOT)**
- **Sprint Nextel (S)**
- Technology darling **Apple (AAPL)**

Step 4. If you own technology-linked ETFs, get out now while the getting's still decent. That includes the **Technology Select Sector SPDR Fund (XLK)**, the **PowerShares QQQ (QQQQ)** and the **Semiconductor HOLDRs Trust (SMH)**.

Step 5. Ditto for mutual funds like **Jacob Internet (JAMFX)** and **Fidelity Select Network & Infrastructure Portfolio (FNINX)**.

Step 6. Can't sell? Then consider hedging with an inverse ETF like **REW**.

Transportation Stocks: Caught Between Inflated Energy Costs and a Sinking Economy

Transportation stocks are getting whacked from both sides.

Your steps:

Step 1. If you own any stocks in this sector, use rallies to unload. That includes big names like **United Parcel Service (UPS)** and **FedEx (FDX)**.

Step 2. Also sell ETFs and mutual funds like **iShares Dow Jones U.S. Transportation Average Index Fund (IYT)**, **Fidelity Select Transportation Portfolio (FSRFX)** or **Rydex Series — Transportation Fund (RYPIX)**.

Step 3. For stocks in this sector that you cannot sell, be sure to maintain a solid position in inverse ETFs, such as those we recommend in our Model Portfolio. (See your regular issues of *Safe Money Report*.)

Corporate Bonds: Ratings Collapsing! Treasuries Shine!

If you think corporate bonds are a safe haven, think again.

The debacle in bond insurance ratings underscores our long-held view that Moody's, S&P and Fitch were inflating their ratings.

And the unspoken truth about virtually *all* bond ratings they issue — the fact they're literally bought and paid for by the issuers themselves — should make you doubly suspicious.

The end result: *The Big Three rating agencies are often too slow to downgrade despite obvious financial troubles!*

We've been a vocal critic of this cockamamie rating system for many years. And now, the chickens are coming home to roost — not a good time to be owning corporate paper of any kind, whether high rated or low rated, short term or long term.

Yes, the Fed's aggressive rate cuts naturally give bonds a temporary price boost. But whenever a bond's rating falls, its price must fall in tandem. And in the longer term, when investors can more plainly see the consequences of the Fed's money pumping — inflation — bond prices are bound to fall even more.

As an illustration, consider home builder Hovnanian. It sold a $150 million batch of 10-year senior subordinated notes with a coupon of 8 7/8% back in September 2002. In mid-2007, those notes were trading around par, or at 100 cents on the dollar. But as soon as fears surfaced about the builder's financial future, they lost more than half their value.

Wall Street itself estimates that default rates on high-yield bonds will surge to as high as 8%. So brace yourself for sharper declines ahead.

In contrast, short-term Treasuries are, fortunately, very *un*exciting — and that's precisely why we have consistently advocated them. Even with the highest yielding alternatives, you simply weren't being paid enough extra interest to compensate you for the extra risk.

Your steps:

Step 1. Sell all high-yield bonds or bond funds. Prime examples: **Integrity High Income Fund (IHFAX)**, **Oppenheimer Champion Income Fund (OPCHX)** and the **iShares iBoxx $ High Yield Corporate Bond Fund (HYG)**.

Step 2. Seriously consider selling all corporate bonds regardless of rating. We expect the higher rated funds to outperform low-rated funds and equities. But if there are massive downgrades, the risk of price declines is still worth avoiding.

Step 3. If a bond fund invests primarily in government securities with just a sprinkling of corporate bonds, we recommend holding. But if the fund is predominantly invested in corporate bonds, sell. Examples of lagging corporate bond funds (based on 1-year performance) include **Legg Mason Partners Investment Grade Bond Fund (SIGYX)** and **T. Rowe Price Corporate Income Fund (PRPIX)**.

Step 4. Move most of the proceeds to short-term Treasuries or equivalent.

Step 5. Allocate some of your money to a global bond fund that's focused on government securities of the world's most stable countries. (See *Safe Money Report* for our favorite.)

Bank CDs and Other Deposits: Make Sure Your Bank Is Safe!

In recent years, Americans have chosen their bank based almost exclusively on yield. Few people worried about bank failures; and indeed, between mid-2004 and early 2007, there was not one single failure among FDIC insured-banks.

But now, that's changing.

The deeper the recession, the greater the risk of bank failures. And make no mistake: Banks have been punched from three sides ...

- The delinquency rate on fixed-term home equity loans surged to its highest level since late 2005.
- The delinquency rate on revolving home equity lines of credit surged to its highest level since late 1997.
- And the delinquency rate on prime credit auto loans surged to its highest level since 2001, when the economy was last in recession.

Of greatest concern: Most of this took place *before* a recession got underway, begging the question: *What happens when the recession strikes with full force?*

FDIC insurance now generally protects up to $250,000 per depositor per insured bank. But if you have deposits above that level, the excess funds could be in jeopardy.

Your steps:

Step 1. Determine the safety rating of your bank ...

- Go to www.TheStreet.com.
- Near the top right of your screen, find the menu item "Portfolio & Tools."
- Select "Bank & Thrifts Screener."
- You will see a green box to enter your information. Under "Bank Name," type in *only the first word* of your bank's name. For example, if your bank is "First National," type in strictly "First." If it's Bank of America, enter just the word "Bank." Then click on "Go."
- If the first word of your bank's name is a very common word, such as "First" or "Bank," there will naturally be many to display. So to

make it easier to find *your* bank, you may want to expand the *number* of banks listed. To the right of the green box, click on the "down arrow" next to the word "display" and select "50" or "100."

- To the right of each bank name, you will see its rating. A is excellent, B is good, C is fair, D is weak and E is very weak. The plus sign means the rating is in the upper third of the range for each grade; and the minus sign means it is in the lower third.
- If your bank is rated C+ or lower, seriously consider avoiding the risk and inconvenience of a possible future failure by switching to another institution.

Step 2. For your day-to-day checking and other banking needs, favor high-rated banks in your state. To find them ...

- Leave blank the space under "Bank Name."
- Next to "Company Type," click on the down arrow and select "Banks."
- Next to "State," click on the down arrow and pick your state.
- Under "Rating," click on the down arrow and select "A — Excellent."
- In the box just to the right, click on the down arrow and select "only." You should immediately see a list of A, A- or A+ banks in your state.

Step 3. For most of your checking and savings, use a Treasury-only money market fund, which generally offers a better combination of safety, liquidity, convenience and yield than banks.

Step 4. For the advantages of short-term Treasuries and how to use them to maximize your liquidity and yield, see our report, "Better than Money in a Bank."

Investment Real Estate: Too Soon for Bottom Fishing!

Are we near a bottom? Not yet. A lot of bad mortgage debt has yet to unwind. We still have not seen most of the impact of the recession. And more distress selling is still likely.

Your steps:

Step 1. If you're selling, price your home like you mean it. Instead of cutting your prices in dribs and drabs and always trailing the market, cut it aggressively now. Consider using incentives to attract interest. No matter what, don't get stuck with sinking property values just because you can't get the price you hoped for.

Step 2. If you're looking for a new home, rent for now if possible. If that's not a viable alternative and you must buy now on credit, favor a 30-year fixed-rate loan. But make sure you have enough cash for a decent down payment.

Step 3. If you're an investor in residential real estate, don't be tempted by price drops of 40% or more in some locations. It's too soon for bottom fishing.

Step 4. If you invest in commercial property, get out now while the market is still not far from its peak. Commercial property valuations got nutty during the recent boom, while capitalization rates plunged sharply. It's going to take a sizable drop in property values to get the cap rates back up to anything near normal.

Step 5. Sell REITs. They have fallen since we flagged the sector as a wealth-destroyer more than a year ago. But the decline is far from over. The recession will drive vacancy rates up and absorption rates down, while keeping a lid on rents, especially in the office and retail sectors.

Step 6. If you are still exposed to the risk of falling real estate — whether residential or commercial — seriously consider a protective hedge, using the **UltraShort Real Estate ProShares (SRS)**.

Your Overall Goals

Goal #1. Get rid of the poison in your portfolio by selling vulnerable stocks. Ditto for corporate bonds and real estate.

Goal #2. Raise cash! Check regularly our *Safe Money* Model Portfolio for what percentage we're recommending for your cash and where we feel you should put it.

Goal #3. Protect yourself from a dollar decline. Our Model Portfolio seeks to achieve that with allocations to foreign currencies, gold and natural resources. (For more on each, see our report, "Currency Riches 2009.")

Goal #4. Few investors can clean house entirely. You may have pension funds that you don't control, real estate that has no buyers, or illiquid interests in businesses that you cannot sell. In each case, do your utmost to find vehicles to hedge against declines, such as inverse ETFs or select put options. (For more on each of these, see our reports, "How to Protect Your Stock Portfolio From the Spreading Credit Crunch" and "Options Investing 101.")

Goal #5. Often the best defense is a strong offense. If you agree, seriously consider using inverse ETFs and/or put options to go for major profit opportunities.

Bottom line: The flood of events is undeniable — most U.S. stocks falling, the home market crashing, high-risk derivatives blowing up, the recession hitting hard, bond insurers collapsing, and the Fed printing money like there's no tomorrow.

So *now* is the time to climb to safer, higher ground. Then build an ark of protection that would make Noah proud.

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