



It's Far Worse Than You Know... That's the Good News

The Western world is broke.

It became that way by indulging in a whole series of socialist programs – such as mandating that Fannie Mae and Freddie Mac support mortgage credit from borrowers who weren't creditworthy. In Europe, the main culprit wasn't mortgage credit, but sovereign credit. Various banking rules encouraged reckless lending to peripheral governments whose credit profiles were falsely enhanced by membership in the euro.

For decades, the wealthiest nations in the world have run their financial affairs like the poor folks at the check-cashing store on Fridays. They've lived far beyond their means, so they could buy the nation-state equivalent of menthols and Old Crow. The U.S., which had been the largest creditor to the world, has become the largest debtor in history. Even today, its federal government continues to borrow more than \$1 trillion a year, in order to maintain a military budget that's already larger than what the rest of the world combined spends on its military and a medical establishment that consumes almost 20% of GDP, more than twice what any other developed nation spends on health care.

This is financial insanity on a scale the world has never seen before. And rather than making any substantial changes... we've addressed the financial crisis by borrowing more and spending more.

The result is going to be a global catastrophe.

Please understand... we know there were plenty of bad actors in the private and public sector. But governments created the structures and the incentives that drove the markets to such excess.

For example, Countrywide Financial – the worst of the worst subprime mortgage companies – sold nearly all of its loans to Fannie Mae and Freddie Mac, which were virtual departments of the federal government. Without Fannie and Freddie, there could have been no subprime bubble – no housing bubble at all, actually.

Both the Treasury secretary and the Federal Reserve chairman testified before Congress in the summer of 2008 that these government-sponsored mortgage giants were "adequately capitalized" just weeks before they essentially went bankrupt. There's no question that those were the biggest lies told by anyone, at any time during the credit bubble. Meanwhile, many analysts, including writers at the *Wall Street Journal*, had been warning the

Inside This Issue

- We've Learned Nothing
- How to Build Your Portfolio During a Crisis
- One Stock I'm Ready to Buy Today
- Returning to One of Our Favorite Shorts
- Why I Think Stocks May Rally

Editor: Porter Stansberry

public about the problems at Fannie Mae and Freddie Mac since 2003.

At every turn, two Democratic lawmakers – Rep. Barney Frank (Mass.) and then-Sen. Christopher Dodd (Conn.) – defended the companies. Make no mistake, the blame for the crisis lies squarely at their feet. Without the multitrillion-dollar expansion of Fannie and Freddie's balance sheets, the housing bubble would not have occurred.

In Europe, to support the creation of a currency backed by nothing (not even a political union), banking regulations were put into effect that allowed commercial banks to hold all forms of European sovereign debt without any reserves. As a result, credit spreads between places like Greece and Germany converged, as was required for the success of the euro. But as all investors should have known and are about to find out, Greece isn't Germany. The Greeks have an entirely different culture in regards to working, debts, and taxes.

The irony is, none of the people truly responsible for making these rules and setting the euro crisis in motion will ever have to answer for their crimes because they sit in the highest places of government.

To date, I see no reason to believe any major Western power has learned anything from these experiences.

Rather than reducing the power of the central governments and reversing the massive government debts, every action taken since the fall of 2008 has increased the role of the government and amount of borrowing. Spending, taxes, Federal Reserve manipulation, government debts... we've gotten more of all of the things that caused our economies to collapse in the first place. This indicates to me we are a long way from learning *anything* from our past mistakes.

Of critical importance are a few obvious, troubling trends...

1) The tendency to use the Federal Reserve (and its counterpart, the European Central Bank) to close fiscal holes and grossly manipulate credit markets (interest rates). Over time, this will lead to inflation and could result in the loss of the U.S. dollar's standing as the world's reserve currency. In the short term, these actions greatly decrease confidence in the U.S. dollar.

2) The narrowing of the tax base and the growing public preference for "millionaire's taxes." Societies that "eat the rich" are quickly destroyed as the natural limits to public spending disappear. And the rich flee.

3) The takeover of state and local governments by unions and the corresponding skyrocketing amounts of state and local debt. California lifeguards making \$100,000 per year *in retirement* at age 40 are only one symptom of an enormous problem.

4) The growing realization of the public that the government cannot and will not deliver on most of its promises. Already, I see major media campaigns to organize senior voters into threatening any lawmaker who attempts to moderate Medicare spending... And yet there is no doubt that within 20 years, Medicare spending will bankrupt the U.S. How will our democratic system permit such benefits to be altered?

5) The real near-term possibility of several major sovereign and public debt defaults: Greece, Ireland, Portugal, California, and Illinois.

These problems all speak to a significant, fundamental problem. Quite simply, the kind of mixed economy that's grown to dominate the West – where capitalism is expected to provide benefits for the government to regulate and re-distribute – isn't working. Far too much power ends up in the hands of major corporations and the government. Far too little economic sovereignty is left with individuals.

I can't know exactly how these problems will resolve themselves. But history tells me the resolutions will be violent and painful. It is not easy for people to come to grips with the fact that, for their entire lives, they have believed in a myth. It will not be easy for people to accept that, like it or not, the government programs they have paid into and relied upon for decades cannot deliver.

And that is why I continue to urge my readers to be cautious with their financial affairs.

Why the Market's Rebound Isn't Going to Last

Lately, the markets have rebounded significantly, based on the hope that Europe can somehow contain

the fallout from a Greek default.

Such a painless and happy resolution is a pipe-dream. The first major European bank to fail, Dexia, was a major holder of Greek debt. It couldn't survive even a 21% decrease in the value of its Greek bonds. I'm certain the public has no idea what the impact on the European banking system will be if Greek bondholders are asked to write off 50% of the value of their bonds.

The European crisis is far from over. And as I've said many times, the endgame will be a bailout of the entire European banking system organized and financed by the Federal Reserve. Such an action would be *hugely* inflationary and could have severe political consequences in the U.S.

Likewise, I don't believe we have even begun to scratch the surface of the real financial problems we face in the United States. Think about the big picture... As of today, Americans owe \$55 trillion in combined federal, state, local, corporate, and personal debt. The interest on these debts comes to more than \$3.6 trillion each year – more than the entire federal budget. I don't believe debts of this magnitude (almost 400% of GDP) can ever be repaid – or even financed – with sound money on legitimate terms.

The resolution of these debts will be painful – whether it's through inflation (which seems to be the path today) or default. *I believe it's a fatal mistake for investors to forget that these challenges remain unmet.* Rather than beginning to reduce our debts, we continue to add to them at the federal level at the fastest pace in peacetime history. We are a nation that has become completely addicted to debt. And those kinds of addictions do not end happily.

This is, of course, a financial newsletter, not a political or historical journal. So... how does our fundamental outlook shape our asset allocation and our security selection?

How to Use This Crisis to Build Your Portfolio

You might be surprised to learn that despite the scope and urgency of these problems... I believe we will see excellent opportunities to *buy* stocks. We saw such an opportunity just after the crisis first boiled over with

the failure of Lehman Brothers in the fall of 2008.

From November 2008 through March 2010, we were *extremely bullish* on stocks. And we were right: The period from March 2009 through March 2011 was one of history's greatest increases in stock prices in the shortest amount of time. Stocks hadn't doubled in two years since the election of Dwight Eisenhower.

I believe we will see a series of economic panics – similar to the failure of Lehman and now the Greek default – that will send volatility soaring and stocks crashing. During the panics, the price of everything will fall – stocks, commodities, precious metals, oil, bonds, foreign currencies, etc. But each panic will be met by more and more money creation. Again and again, the central banks will step in to provide “emergency” funding. Again and again the fundamental problems of our mixed economies – where everyone is trying to live at the expense of his neighbors – will be papered over.

This will make it difficult for investors who simply try to buy and hold stocks. I don't think the markets will ever get too far ahead before they end up crashing again. It will also make things difficult for investors like us, who prefer to buy during the panics and sell near the tops. It is incredibly difficult to get the timing just right. It is perhaps even more difficult emotionally to buy on days when it seems like the world might end.

Just remember this... we are living through a massive financial transition. If you are able to simply keep what you have earned, you will come out far ahead. These are not simple times. And I'm afraid we are going to see a lot more trouble in the months ahead.

The first thing you must do is save. You must consume less than you earn. My colleague Dan Ferris once counseled a reader to save \$50,000 before buying anything other than gold bullion. The reader was incensed. But there was real wisdom in what Dan was saying. To become wealthy, you must first learn to be a saver. Only after you have mastered the art of saving does investing become possible. Until that point, you are really only gambling.

Hold your savings in gold and/or silver. As I've said many times before, I believe you ought to hold at least 15% of your liquid net worth (which doesn't

include your primary residence) in physical gold or silver. I personally prefer gold. It is less volatile and that helps me sleep at night.

I know many people prefer silver because they believe (rightly) it is likely to go up far more than gold. That's fine. But I prefer gold. I'm confident that the world's central banks will be net buyers of gold for the next several decades. The future role of silver in the world's currency markets is far less certain.

Hold Gold Bullion – Not ETFs

I believe it is critical to hold physical bullion, not an exchange-traded fund (ETF) that invests in gold. The volume of contracts that trade on the futures markets (where ETFs control a lot of metal) dwarfs the amount of actual physical gold in the entire world. This indicates two things to me...

First, the price of gold is likely depressed by selling in the futures markets. Whether that's a conspiracy or simply good trading, I can't say. (I will say that no one in his right mind would be selling gold futures today, unless he had some backing from the U.S. or the European central banks.) But whether the price of gold and silver is manipulated doesn't really matter to me because, like it or not, the price is eventually going higher.

The second thing the volume of futures trading relative to the supply of gold tells me is... sooner or later... there will be a run into physical gold. When that happens, the futures markets will collapse because there won't be enough metal to meet demands for physical delivery. What happens to the ETFs in this scenario is anyone's guess.

The good news is, as long as you've got your own bullion hidden away somewhere safe, you won't have to worry about it.

The other reason to prefer gold bullion is that it's harder to trade than shares of an ETF. You can't sell bullion with the click of your computer mouse. You've got to call several dealers, find a price you like, box it up, and ship it out. This effort is an incentive to simply hang on to your gold, which is exactly what you should do with it. I've been buying gold regularly for seven years now. I've never sold a single coin. And I won't, as long as the world's economy is organized

around a purely paper standard.

The Proper Role of Equities

Most people buy stocks with the idea that their share prices will go up by 20% or 30% in a year, allowing them to sell relatively quickly with a healthy profit. They truly don't understand the concept of compounding returns or why anyone would want to hold the same stock for decades.

The reason you want to own common stocks is that (ideally) they grow their earnings over time and increase the amounts of their payouts to investors. Reinvesting these payouts (in either the same stock or others) allows you to greatly increase the return from your equities over time.

Increasing earnings and dividends also protects investors from inflation – but only if they buy the right kind of stocks and only if they hold them for the long term. I'll show you exactly how to do that today.

At various points over the next several years, you should strive to acquire a portfolio of high-quality common stocks at safe and cheap prices. Over the long run (20 years or more), this is the best and most surefire way of building wealth. It should be easy to do... And yet... most people will find themselves completely unable to master the discipline it requires.

Now... I can imagine you're saying to yourself, "Wait a minute... Porter says the U.S. dollar is in jeopardy of a collapse, that the Western world is broke, that it's all going to hell... And now he's telling us to buy stocks?!"

Remember, my advice is to acquire a portfolio of high-quality common stocks *at prices that are safe and cheap*. "Safe and cheap" means the company has enough earnings and cash flow to realistically take itself private at current interest rates. That is, the company's shares trade at a price low enough that the company could realistically buy back all of its shares. You don't need to perform this buyout analysis. A simple rule of thumb is, we don't want to pay more than about 10 times a company's cash earnings.

High-quality common stocks represent businesses that are protected from competition and technology and can produce tremendous rates of return for their owners. Look for companies that routinely

earn more than 10% a year on their unleveraged assets. That's difficult to accomplish, and it is a strong indication of a great business. But you must use your own common sense to evaluate how protected they are from future competition and technology.

Then... and this is the most important part... make sure you only buy *extremely* capital-efficient companies to hold for the long term. Most public companies – even the ones with great products and profits – only return a fraction of their profits back to their owners. Instead, the capital is destroyed through absurd investments, mergers, and criminal amounts of executive compensation.

I measure capital efficiency by looking to see how much of the company's gross profits end up being paid out to shareholders in the form of dividends or share buybacks. Who ends up with the profits? Management? Bankers (in the form of interest payments)? The company itself, due to heavy capital investment? Or investors?

The importance of capital efficiency is not well-understood by most investors, but it is absolutely critical.

Companies that don't require much capital to grow will, as they get bigger, return higher and higher percentages of their gross profits to shareholders. As inflation hits, prices rise, and common stock profits grow, these kinds of companies will provide an excellent hedge against inflation – even better than gold.

The trick is, you must develop the discipline to buy them when they are *safe and cheap*... To the right is a simple list of 20 high-quality, capital-efficient companies that are trading at or near a *reasonable price*.

The columns show the company's capital efficiency over the last 10 years. Out of all the money it made in gross profits, what percentage was distributed to shareholders?

The second column is a modified version of the price-to-earnings ratio, which simply tells you how many years of a company's cash from operations it would take to buy the entire company (including its debt). In general, we are seeking to buy these kinds of companies for less than 10 years' worth of cash earnings – although that's sometimes adjusted to account for significant amounts of future expected growth.

Finally, the last column shows you the company's latest annual return on assets, which is a measure of the company's overall profitability.

As you can see... there are few bargains.

The only names that look particularly attractive are both tobacco companies, where sales and earnings are likely to fall over the next decade as people stop smoking. So even though I want to own most of these businesses... I wouldn't recommend buying any of them today.

It's difficult to buy stocks like these at a great price because there is almost always plenty of investor demand for these shares. With the exception of a company in the midst of an accounting scandal or some other kind of unusual internal event, you will only have the opportunity to buy high-quality common stocks at prices that are *safe and cheap* during periods of mar-

Company	Cap. Eff.	P/E*	ROA
Lorillard	66%	8.6	35.1
Lancaster Colony	42%	20	17.6
Microsoft	41%	10.1	23.8
Clorox	37%	17.6	12.8
Exxon	37%	13.5	11.4
Philip Morris	33%	9.4	20.9
Rockwell Collins	32%	18.5	11.6
Kimberly-Clark	32%	19.7	9.4
Altria	31%	10.3	10.5
Intel	29%	14.8	19.7
Nat'l Presto	29%	19	15.5
Procter & Gamble	26%	19.1	8.9
Dun & Bradstreet	26%	11.6	13.8
IBM	22%	17.9	13.3
Campbell Soup	22%	10.1	12.3
McGraw-Hill	22%	10	12.2
CR Bard	21%	16.7	16.8
3M	21%	17.2	14.2
Choice Hotels	20%	18.2	28.6
Heinz	19%	21.7	8.9
* Our modified price-to-earnings ratio is: enterprise value/cash from operations			

ket panic. That's why it's important to remain open to buying certain kinds of equities even now, when we're expecting a long period of economic turmoil.

The key is to make sure you only buy the highest-quality businesses. These are the kind of companies you want to own for *decades*.

Master investor Warren Buffett, for example, famously purchased his position in the Washington Post Co. in the midst of the great '73-'74 panic, when stocks fell by about 50%. He paid four times earnings. Likewise, following the crash of 1987, he purchased his gigantic stake in Coca-Cola, perhaps his single greatest investment of all time.

I'm sure I'm going to take all kinds of flack from some of our subscribers who are permanently bearish. They won't ever buy a stock again because they believe the financial crisis we face will mean the end of the world. They're making a huge mistake. I know how much trouble our country is in. And while it might not be easy for the next several years, we will get through it. The people who will get through it the best are the folks who keep their eyes open for opportunities during the worst parts of the crisis.

I hope that will be you.

Of course, it's one thing to say "*buy good companies when they're down*," but it is quite another thing to actually do it. It's much, much harder than it looks. You have to overcome big emotional obstacles to buy when everyone else says, "Sell."

Be Prepared to Buy

What I'd recommend you do is simply become familiar with the basics of those companies above. Read their annual reports. Follow their progress. Keep an eye on their share prices. Decide which ones you would like to buy and the price you are willing to pay. When the panic arrives, you will be prepared to buy. It will be much easier if you prepare this way. Again, you're trying to get these companies at prices around (or below) 10 times current cash earnings.

The best part about buying these kinds of stocks is the rich payouts to investors. These companies operate consistent, global businesses. They will continue to pay their dividends and make share buybacks... whether the euro disintegrates... whether the U.S.

dollar is devalued... whether we go to war with Iran, etc. This stability and the size of the payouts allows you to judge the success of your investment by the capital you get back from the company, instead of merely the share price. This will enable you to withstand the volatility we're likely to experience over the next several years.

Take Campbell Soup. It's been making roughly the same amount of money (about \$3 billion in gross profits) in each of the last three turbulent years. That doesn't sound like much growth – and it's not. Likewise, the share price hasn't moved much over the last five years. It's just bounced around between about \$25 and \$35. That doesn't sound very good, does it?

But then, factor in this: *Last year, Campbell Soup returned more than \$1 billion to its shareholders in the form of cash dividends and share buybacks.* The company's entire market cap is a little more than \$10 billion. So in terms of return on their investment, shareholders earned about 10% over the last year. Plus, as the share count is reduced, the stock they own is worth more and more as a percentage of the total.

If this keeps up for a few years, sooner or later the share price will soar, as will the value of the dividends being paid. If you're making 10%-20% a year in the form of capital distributions, you quickly learn to ignore the ups and downs of the share price, especially when you own an asset as stable and efficient as Campbell Soup.

That's real investing. That's exactly how you do it – over the long term, with super high-quality companies you've bought at a good price.

Ideally, you'd augment your savings with a handful of these kinds of great investments. It doesn't take many. I'd recommend investing around 25%-50% of your liquid assets into a program of disciplined, high-quality investing. This should leave you plenty of capital for investing in bonds and holding cash. And if you buy these stocks at the right price and reinvest the dividends, you'll see the size of your holdings grow substantially over the long term.

As I said earlier... this is harder than it looks. You've got to be certain the company is sound and it's going to be around for a long time. You need to be sure the company you're buying will maintain its capital efficiency. And you, the investor, must have the

financial ability to hold it for a long time.

The ‘Advanced’ Course: Getting the Price You Want, Plus Lots of Income

Now... I know some of you need more income than this strategy provides. There are simple things you can do to increase your income from a strategy like this. My favorite is to sell out-of-the-money puts on companies, like Campbell Soup, that you either hold or want to hold as part of your long-term nest egg. You can pick a strike price based on the price you’d like to pay to own it.

And if the stock trades down to that strike price, you will end up being “put the stock.” That means you’ll have to buy the stock at the strike price, which is fine because you wanted to buy it anyway. If the stock doesn’t trade down that far, that’s fine, too. You’ll get to keep the “premium” you received just for promising to buy it. Ideally, that premium should represent about 5% of the stock’s price.

This is the “advanced” course. If you’re not familiar with options, don’t worry. You can do fine as an investor without ever buying or selling an option. But selling options on high-quality stocks is the only way I know to make a lot of money in the markets without taking any real risk – especially during periods of market turmoil.

So... when you see market volatility (as measured by the Volatility Index, the “VIX”) shooting up and the Dow falling several hundred points each day, that’s when it’s time to call your broker and tell him to sell a few put contracts on your favorite high-quality stocks. Worst-case scenario, you get the stocks you wanted to buy at a price you think is attractive. Best-case scenario, you make 50%-60% on your capital, on an annualized basis, without taking any real risk or buying anything.

This technique, by the way, is exactly how Warren Buffett ends up buying huge positions in high-quality companies. For example, he sold a lot of puts on BNSF railway, going into the financial crisis in late 2008. Soon after, he ended up buying the entire company.

(If you’re interested in learning more about this technique, consider signing up for the options course I’ve developed with Dr. David Eifrig, who is a former

prop trader at Goldman Sachs. Nobody knows more about selling options than Doc.)

One Stock I’d Buy Today

While none of the great, proven blue-chip stocks I listed earlier are cheap enough to buy now, there is a company that’s becoming a great business that I recommend you invest in today.

It didn’t qualify for our pantheon of capital efficiency because it was created via a merger in 2008. So it simply doesn’t have the pedigree. Also, as a *video game publisher*, many investors would argue the technology in play in this space is too uncertain. I disagree. Publishing is a business I know well... and I know technology *empowers* publishers. It allows them to more easily connect with their customers. That’s certainly the case with this stock.

Before I tell you any more about the business, let’s review the numbers.

In the full two years since the merger, this company produced \$4.2 billion in gross profit. That’s revenues minus the cost of sales – before all operating costs and capital investments. In those same two years, this company distributed \$2.1 billion to shareholders in the form of cash dividends and share buybacks. That’s a capital efficiency of 50%, which would put it No. 2 on our pantheon above, just behind the tobacco company Lorillard.

In terms of price, the company’s shares trade for an enterprise value of \$11 billion. (Enterprise value is market cap plus debt minus cash.) The company generates roughly \$1.5 billion a year in cash from operations, which puts its modified P/E at 7.3x. This falls well below our price threshold of 10 times cash earnings.

Is this a high-quality business? At first glance, you’d say no. Yahoo Finance reports the company’s return on assets is only 5.9% – fairly pedestrian. Its return on equity is only 6.15% – nothing to brag about. But these numbers prove you have to do your homework...

You can’t simply rely on databases and computer-generated numbers to define what stocks you buy. Remember... I explained this company is the product of a recent merger. The way merger accounting works, the purchase price of the deal in excess of the net tangible value of the company being acquired

gets recorded as “goodwill” on the balance sheet. So when you look at this company, you will find more than \$7 billion of goodwill. It’s a completely meaningless figure, except that it reduces the recorded returns on assets and equity.

Simply take out the goodwill number (which is an accounting fiction) and you end up with a company that holds \$6 billion in assets (not \$13 billion). On these \$6 billion in assets, it’s earning \$1.5 billion in cash each year. That’s a return on tangible assets of 25%. And that’s a much more accurate representation of its business.

To summarize, compared to our pantheon of the greatest common stocks in the world, this company has the *second-highest* capital efficiency, *third-highest* return on assets, and the *lowest* price. I hope that explains a lot about what I see in this opportunity. But there’s an even bigger reason I like it...

As a publisher... I know this is a *great* business. Technology is making video games into active, online communities where people spend hours of leisure time. These communities are growing. And they are powerful, allowing publishers to increase prices and fees. That’s a trend I believe will continue at the same time technology allows richer experiences and lower connectivity costs.

Technology will also allow these publishers to adopt higher-margin distribution models, where players are able to pay the publisher directly, buying the game through subscription, instead of through a retail outlet. These trends are why I’m extremely bullish on the long-term future of the video game business.

Consider this: In the five days following the company’s last major game franchise release, it sold \$650 million worth of the title. That’s not total sales for the year – *that’s just five days of sales*.

And finally... for investors... this stock comes with an ace in the hole. Vivendi, the large French media company, owns more than 60% of it. Vivendi made the acquisition during the merger that created this business in 2008. It can only make its money back if the company continues to return capital. And since Vivendi controls the company, you can be certain that’s going to happen.

This majority shareholder situation scares some

investors, but not me. I actually prefer to “partner” with large investors that have much more skin in the game. What scares me are reckless management teams, not fellow investors. And when a fellow investor holds more than 60% of the stock, the management team doesn’t have much room for error. I like that.

As you might have figured out by now, the company I’ve been describing is **Activision Blizzard (Nasdaq: ATVI)**. It’s one of the three major video game publishers in the world (along with Electronic Arts and Take-Two Interactive). It has two main franchises. The first is *Call of Duty*, a “first-person shooter” game. Players take the role of soldiers in various combat situations. The game is massively popular and allows people to play together online. This is the franchise that sold \$650 million of product in five days.



The company’s other main franchise is potentially even bigger. It’s called *World of Warcraft*. It is a massive multiplayer online role-playing game (MMORPG). Currently, *World of Warcraft* has attracted *11 million subscribers*, who develop characters in an alternate universe. This is a whole new form of entertainment, something that wouldn’t have been possible before the advent of low-cost broadband connectivity.

And because access to the game is sold via subscription, the margins are incredibly high. In 2010, the company sold \$3 billion of products at a cost of \$1.3 billion. It sold \$1.3 billion of subscriptions at a cost of only \$241 million. Product sales as a percentage of total sales are falling as subscription sales continue to grow. And that means the company’s gross margins are likely to expand substantially over the next few years. Given the company’s *extraordinary* capital efficiency, most of these extra profits will wind up in the pockets of shareholders.

Action to take: Buy Activision Blizzard (Nasdaq: ATVI) up to \$15. Use a 25% trailing stop loss.

Shorting First Solar... Again and Again and Again

Take a look at the chart below...

It shows the last five years of trading in the shares of **First Solar (Nasdaq: FSLR)**. We first recommended shorting this stock in January 2008 – close to its all-time peak. At the time, we hadn't thought much about the physics behind solar panels that use photovoltaic (PV) semiconductor technology or the politics behind Germany's massive investment into them. We simply had seen enough tech stocks like First Solar to spot a bubble.



As we wrote at the time: “The first stock I’d like for you to short this year is so absurdly overvalued and overhyped that I won’t waste your time with a detailed explanation. You won’t need it.”

Back then, the company had an \$18 billion market cap. It was selling a product that no one in his right mind would ever purchase because it’s just about the most expensive way possible to generate electrical current.

As it turns out, almost all of its sales were coming from the German government, which was bound and determined to make one of the dumbest investments in history – although I didn’t fully realize how dumb at the time.

I did know First Solar’s technology wasn’t that great. It wasn’t the most efficient type of solar panel, nor would it ever become so. Making the panels was

expensive because they used lots of expensive semi-conducting materials like cadmium telluride. Competition from poly-silicon solar panel makers would reduce gross margins. I made a simple prediction. First Solar would never make much money, and its share price would get destroyed...

What will actually happen is what always happens to very expensive stocks. Things go wrong. The price of oil and energy in general falls as the world slips into recession. Suddenly, the idea of paying for solar panels seems dumb, given the low cost of energy and budgetary constraints on governments around the world. The global-warming fad fades. People forget. And First Solar ends up like so many other promising tech startups – busted. Maybe I’m being too pessimistic. Maybe solar power will finally break into the mainstream. Even if that happens, it will be a very competitive business. It won’t be easy for First Solar to grow its revenues this fast for long. The realities of manufacturing will manifest themselves. Growth will slow; margins will shrink. I’m happily willing to bet that First Solar won’t earn \$1 billion in net income in my lifetime. – Stansberry’s Investment Advisory, January 2008

Technically, I was wrong about the \$1 billion in net income. I should have been more precise in my language. I never pay any attention to net income, which is merely an accounting fiction. What really matters is free cash flow – how much money does a company make that’s available to be reinvested in the shares or paid out to investors? In 2008, it produced a grand total of \$4 million in free cash flow. In 2009, that number seemed to have soared to more than \$396 million... But all that really happened was First Solar shifted \$400 million in capital spending to the investment line. It actually lost money on a cash basis in 2009. Finally in 2010, it made \$117 million in cash... for a grand total of real, free cash flow of around \$100 million over the last three years.

And things are about to get a lot worse for First Solar...

The company has two big problems. First, its competitors can now make better solar panels for less, using polysilicon. And second, the Germans just came to their senses. Of the two problems, the Ger-

man issue is the most important.

I never spent much time looking into the German solar subsidy regime. I knew Germany paid subsidies for solar installations. But I never realized just how insane the subsidies were. These folks totally lost their minds...

In 2000, the Germans passed the Renewable Energy Sources Act. It required electric utility companies to pay a "feed-in tariff" to any consumers who installed solar panels on their properties. The average consumer price for electricity in Germany is about \$0.20 per kilowatt hour (kWh). But the feed-in tariff for solar panels was set at nearly \$0.51 per kWh in 2000. And here's the kicker: These feed-in tariffs must be paid for the next 20 years.

The University of Ruhr economic department has published the most thorough study of the economic consequences of these tariffs. According to the study, by 2009, more than \$12 billion was being spent on feed-in tariffs annually. Based on the amount of installations completed through the end of 2010, the study concludes that the current total cost of Germany's PV solar investment will exceed 50 billion euros.

And what has Germany gotten for this investment? The latest figures show PV solar power now makes up 0.6% of the total electricity that's produced in Germany.

Incentives are powerful things. If you pay people to do something, they will do it, even if it is incredibly stupid. The Germans decided they wanted solar power, no matter the cost. And the public responded.

Germany made up more than half of the global demand for solar panels for most of the last decade. Total installed solar capacity in Germany has soared, from 100 megawatts to more than 5,000 megawatts. But planting a bunch of really expensive silicon around the country hasn't led to any substantial increase in electrical production. Why? Because as I've explained many times, the technology simply doesn't work. When the panels heat up, the amount of electricity they can produce falls. And it's not that sunny in Germany. Nor does the sun shine at night. Nor is PV electricity well-suited for distribution on the power grid.

The technology suffers from many fundamental physical problems. That's why PV solar power

is completely uneconomical – as Germany has just discovered. But only after losing 50 billion euro.

As I said, the Germans have finally come to their senses. The country recently moved to change the law so that the amount of the feed-in tariff falls by 10% annually and starts out at a much lower rate. The result is that installing solar panels is no longer a free way to make money in Germany. As a result, German demand for solar panels is disappearing.

I wonder how Germany will feel about PV solar panels in 20 years, when it finally stops paying for the panels it's got now. The panels themselves are only expected to work for 15 years, by the way. My bet is, 20 years from now, the Germans are going to wish they'd bought 10 or 15 nuclear power plants instead of all of those solar panels.

In any case, the future for thin-film solar panels (the kind First Solar makes) is grim. No one should have ever bought the damn things in the first place... And the company that made them couldn't make money selling them, even when the Germans were bankrupting their country to buy them.

Action to take: Sell First Solar (Nasdaq: FSLR) short... again. Use a 25% trailing stop loss.

Portfolio Review

European governments have promised to hold the euro together. That will require colossal bailouts of the banking system. That will weaken the euro and provide still more liquidity to the world's markets.

Meanwhile, we are still showing double-digit percentage gains on our shorts of European bank stocks and of their American counterparts, GE and Capital One. (We apologize for the confusion regarding the tracking of Royal Bank of Scotland. Yahoo Finance, which we use to track the portfolio, was posting incorrect data. We have since corrected our portfolio, which is now accurate.)

I think we should cover our finance-related shorts for now, taking our profits off the table. We may return to these positions at a later time. But... for now... I don't want to fight the European Central Bank. **Close out your short positions in General Electric (NYSE:**

The SIA Blacklist

Ticker	Short Name	Market Cap	P/S	P/E	Total Return YTD
BIDU	Baidu Inc	46,398,390,272	27.99	60.35	37.75
VMW	Vmware Inc	38,264,201,216	11.38	70.79	1.91
PSA	Public Storage	20,317,739,008	11.33	39.00	14.58
ALXN	Alexion Pharmaceuticals	12,433,640,448	18.79	104.47	67.30
CHKP	Check Point Software	11,928,559,616	10.19	24.51	24.49
AVB	AvalonBay Communities	11,203,260,416	10.90	87.60	8.21
RRC	Range Resources	11,022,860,288	10.32	139.67	52.50

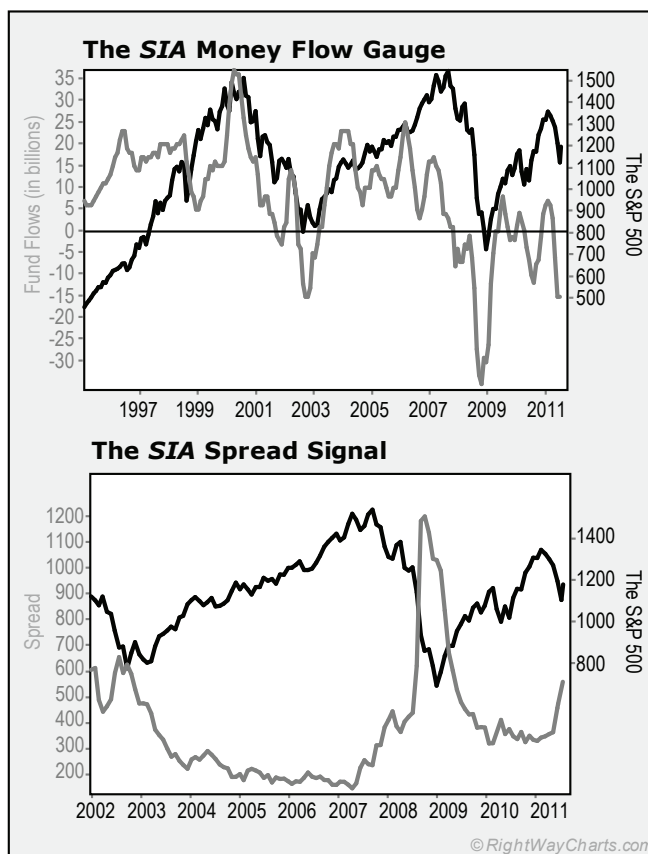
GE), Capital One (NYSE: COF), Royal Bank of Scotland (NYSE: RBS), and Deutsche Bank (NYSE: DB). We'll record gains on these positions ranging from 27.0% (RBS) to 10.9% (GE).

I also believe we should cover our short position in Education Management. I abhor all for-profit education companies... but I'm not confident that the fraud allegations made against the company will stick – even though I believe they should. I don't like being short in a situation where I'm not 100% certain, and I'm not in this case anymore. **Close your short position in Education Management (Nasdaq: EDMC).** The model portfolio will reflect a slim 0.5% gain on the position, essentially breakeven.

Our market indicators show us a significant rally in stocks is likely. In particular, our Money Flow Gauge reveals mutual-fund outflows have grown big enough to be significant. *The volume of selling is roughly equal to what we saw near the bottom in 2002.*

Add to that the Black List has dwindled to only a handful of high-quality names and the spread between high-yield bonds and Treasuries is surging. That tells me unless the situation in Europe boils over immediately, we will almost surely see a 20%-30% rally in stocks to end the year.

While these facts don't alter my fundamental bearish outlook, they influence our balance of long and short positions. They also make me more willing to buy stocks... **So I am moving both Wal-Mart (NYSE: WMT) and Johnson & Johnson (NYSE: JNJ) from "Hold" to "Buy."** These are



good long-term investments, and both trade at attractive prices (both well below 10x cash earnings).

Good investing,

Porter Stansberry
October 14, 2011

Stansberry's Investment Advisory Model Portfolio

Prices as of October 13, 2011

	Symbol	Ref. Date	Ref. Price	Recent Price	Dividends	Description	Action	Return*	Risk
"No Risk"									
Wal-Mart	WMT	09/09/10	\$51.91	\$55.02	\$1.40	World Dominator	Buy	8.7%	5
Johnson & Johnson	JNJ	07/06/06	\$60.52	\$64.23	\$9.89	World Dominator	Buy	22.5%	5
Exelon	EXC	10/09/02	\$21.47	\$42.76	\$15.20	Nuclear power	Hold	169.9%	5
Hershey	HSY	12/06/07	\$40.55	\$59.62	\$4.70	World Dominator	Hold	58.6%	5
The "Next Boom"									
Activision Blizzard	ATVI	10/13/2011	NEW	\$12.92		Gaming publisher	Buy	NEW	2
Silver^	SLV	08/11/11	\$34.10	\$30.94		Inflation Hedge	Buy	-9.3%	2
Dominion Resources	D	07/18/11	\$48.00	\$50.04	\$0.49	Export LNG	Buy	5.3%	3
ConocoPhillips	COP	04/02/09	\$41.45	\$67.04	\$6.23	Cheap oil	Hold	76.8%	5
Calpine	CPN	05/13/10	\$13.93	\$14.06		Nat gas power	Hold	0.9%	5
BP	BP	02/11/11	\$45.93	\$35.22	\$0.84	Cheap oil	Sell	-21.5%	5
Silver Wheaton	SLW	12/01/10	\$37.90	\$31.21	\$0.09	Silver secret	Buy	-17.4%	5
Monsanto	MON	11/18/10	\$59.63	\$73.18	\$1.14	Soaring food	Hold	24.6%	5
San Juan Basin	SJT	01/07/10	\$18.34	\$23.51	\$2.72	Cheap energy	Hold	43.0%	5
Victims									
UltraShort Euro	EUO	05/13/11	\$17.55	\$18.15		Debt crisis	Buy	3.4%	5
General Electric	GE	06/15/11	\$18.55	\$16.22	\$0.30	Debt crisis	Buy to cover	10.9%	5
Capital One Financial.	COF	06/15/11	\$48.00	\$41.87	\$0.05	Debt crisis	Buy to cover	12.7%	5
R. Bank of Scotland	RBS	07/18/11	\$10.59	\$7.73		Debt crisis	Buy to cover	27.1%	5
Deutsche Bank	DB	07/18/11	\$50.78	\$38.51		Debt crisis	Buy to cover	24.2%	5
Education Management	EDMC	8/11/2011	\$17.74	\$17.65		Fraud	Buy to cover	0.5%	5
Gannett	GCI	9/08/2011	\$9.87	\$10.78		Obsolete	Sell Short	-9.2%	5
D.R. Horton	DHI	9/08/2011	\$9.80	\$9.86		Obsolete	Sell Short	-0.6%	5
First Solar	FSLR	10/13/2011	NEW	\$56.85		Obsolete	Sell Short	NEW	5
* This is the return since reference date, including dividends. ^ Price adjusted by profits from selling January 40 calls Stansberry's Investment Advisory's Model Portfolio does not represent any actual investment result. Our reference price represents the price of our recommended securities at the time we wrote the recommendation. Our sell price represents the closing price at the time a reasonable reader would have had the opportunity to sell, typically the day after such a recommendation is given. Please note: Our investment philosophy requires limiting risk through the use of trailing stop losses. Unless otherwise noted, all recommendations use a 25% TRAILING STOP LOSS. NEVER ENTER YOUR STOPS INTO THE MARKET. KEEP SUCH INFORMATION PRIVATE. How to use a trailing stop: A stop loss is a predetermined price at which you will sell a stock in case it declines. A "trailing stop" is a stop loss that "trails" a stock as it rises. For example, let's say you set a 25% trailing stop on a stock you purchase for \$10. If the stock rises to \$20, you would move your trailing stop to \$15 (\$5 is 25% of \$20, \$20 - \$5 is \$15). Only use closing prices, and never enter your stop into the market. For more information, see our frequently asked questions at www.stansberryresearch.com/secure/faq.asp. Our risk label is based on current share price and one-year business outlook. 1 = the lowest possible risk. 10 = the highest possible risk.									

Published by Stansberry & Associates Investment Research.

Stansberry & Associates welcomes comments or suggestions at feedback@stansberryresearch.com. This address is for feedback only. For questions about your account or to speak with customer service, call 888-261-2693 (U.S.) or 410-895-7964 (international) Monday-Friday, 9 a.m.-5 p.m. Eastern time. Or e-mail info@stansberrycustomerservice.com. Please note: The law prohibits us from giving personalized investment advice.

© 2011 Stansberry & Associates Investment Research. All rights reserved. Any reproduction, copying, or redistribution, in whole or in part, is prohibited without written permission from Stansberry & Associates, 1217 Saint Paul Street, Baltimore, MD 21202 or www.stansberryresearch.com.

Any brokers mentioned constitute a partial list of available brokers and is for your information only. Stansberry & Associates does not recommend or endorse any brokers, dealers, or investment advisors.

Stansberry & Associates forbids its writers from having a financial interest in any security they recommend to our subscribers. All employees of Stansberry & Associates (and affiliated companies) must wait 24 hours after an investment recommendation is published online or 72 hours after a direct mail publication is sent before acting on that recommendation.

This work is based on SEC filings, current events, interviews, corporate press releases, and what we've learned as financial journalists. It may contain errors, and you shouldn't make any investment decision based solely on what you read here. It's your money and your responsibility.