



A Great Lesson in the Only *Sure* Way to Get Rich in Stocks

Make sure you save a copy of this month's letter.

It's a step-by-step, paint-by-numbers guide to making a fortune in stocks. No, I can't promise that your investments will pan out as well as a few of mine have over the last few years. But I believe anyone is capable of becoming a world-class investor. You only need to do three things...

1. Find companies that will last.
2. Only buy *capital-efficient* stocks that offer the potential of compounding returns.
3. Buy shares at "no-risk" prices.

Now understand... I have written about these concepts many times before. But I don't think I've ever put them all into one letter before. This represents a summation of 15 years of thinking and writing about investments. This is hard-won wisdom. These are the things I know work – no matter what else is happening in the world or in the markets.

And that's a key consideration... because as good as things feel right now... the real problems are only beginning.

Over the past two months, I've written almost exclusively about these big global economic risks. In December, I painted a picture of the "Corruption of America." I was relieved to discover these ideas resonated deeply with many of you. I didn't expect that... The positive response was overwhelming. I must have gotten 10,000-20,000 encouraging e-mails in reply. That gives me hope for our country. And it deepens my conviction that once people understand what's really happening, we will make better choices.

Then, I spent much of the January issue talking about the real risks our country faces as its currency weakens. I detailed Chinese efforts to take over the financial leadership of the world's economy. If you're new to our letter... or if you missed an issue... please take a moment to review these reports. You'll find them on our website (www.stansberryresearch.com), posted in the *Stansberry's Investment Advisory* section under the link for "Monthly Issues."

But this month... I'm taking a different approach. I'm going to return to the basics of solid investing. For you to do well and prosper during the coming inflationary crisis, it's critical to understand how to position yourself in the right kind of stocks.

And the right kind of stocks might not be what you'd expect...

Finance offers many wonderful ironies. For example, the best time to buy stocks is the moment when no one else will. It's difficult to acquire the discipline to wait for these moments... and it's even harder to master the resolve to do so in the exact moment the opportunity arrives.

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- Why the Coming Crisis Will Be Worse than the Great Depression
- The Real Secrets to Great Investing
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Similarly, when it comes to managing inflation, most analysts (including some of mine) will tell you to buy gold stocks and other companies that own hard assets. And yes, it's true... those can be good stocks to own during periods of massive currency volatility.

Three large mining stocks traded in New York during the Great Depression – Homestake Mining, Alaska Juneau Gold Mining, and Dome Mines Ltd. According to research done by *Barron's* magazine, the average return for all three from 1929 to 1933 was 300%. In the case of Homestake, the returns were even larger. It rose 620% between October 1929 and the end of 1935. By comparison, the Dow Jones Industrial Average fell roughly 60% during the same period.

I won't argue. If you pick the right mining stock, you will do well over the next several years. That's why I've recommended you buy GDX, the exchange-traded fund that holds a basket of gold-producing companies.

On the other hand, the greatest investor of the last inflationary cycle – Warren Buffett – has never bought a gold stock. Instead, he has focused on buying high-quality companies that are extremely capital-efficient. And his results have outpaced every resource investor who's ever lived – by a huge margin.

That's the ironic part... Buffett is the greatest investor of all time, and he lived through the greatest inflation in U.S. history. *But he never bought a gold stock.* How did he do it? His secret is so simple that when I show it to you... you're more likely to ignore it than anything else.

Buffett figured out, long before anyone else I can name, that the best way to profit from inflation wasn't by buying hard assets or the companies that produce them... Instead, you should buy companies that don't require any additional capital at all (or require very little).

For gold-mining firms and other companies that produce hard assets, capital investments represent their biggest expense. They have to buy new gold mines... new oil wells... new machinery... new drills... new assets of every kind. The problem is, to stay in business, they have to sell their current assets. They end up with dollars that aren't worth as much as they used to be when the contracts were written... And they're faced with the daunting prospect of trying to replace the assets they've already sold. But they can't... Not at any reasonable price, anyway.

Buffett figured out companies that don't require much in ongoing capital investments can simply raise their prices to combat inflation. Then, they can pay out the excess returns to shareholders. The result? Higher dividends every year.

In this issue, I'll explain in detail exactly how you can do the same thing.

Why I Hope I'm Wrong About the End of America

First, though... I'd like to show you why I continue to believe we face a massive inflationary crisis and the dollar is likely to lose its status as the world's reserve currency. *Even if you think I'm wrong about these predictions, I still hope you'll take a few sensible steps to protect yourself and your family.*

The thing you have to understand about a currency crisis is... **you get very little warning.** Confidence in a country's paper – its bond markets and currency – can evaporate overnight. I know no one thinks this will happen to America. "That can't happen here..." I've heard that too many times.

Unfortunately, that's wishful thinking. History teaches a far more stringent lesson: *No country in history has successfully run up endless debts and paid them back with worthless paper. The consequences of such actions have always been the same: currency flight and a massive inflation.*

If you wait until the panic to take action, you're going to be stuck with everyone else. When the world begins to stampede out of the dollar, you'll have no place to hide. At that time, no one will sell you anything in exchange for your paper money – not gold, not silver, not even other paper currencies – because there will be so much uncertainty about the future of the dollar.

Even if I'm wrong... even if this moment of reckoning is postponed for decades... I don't think most people can begin to comprehend the inevitable disruptions that are bound to occur because our money supply has *tripled*. It's truly hard to comprehend.

Let's take a brief look at the Great Depression for comparison...

The U.S. economy began to contract in August 1929. Economic activity continued falling until March 1933. From peak to trough, the U.S. economy declined 27% in real terms. Adjusted for inflation, the output of our economy fell by nearly one-third over a period of nearly four years. This was the *worst* economic performance in the history of the United States.

The government responded by increasing the size of the Federal Reserve's balance sheet (increasing the money supply) and ratcheting up deficit spending (fiscal stimulus). Against the size of our economy at the time, the combined stimulus measured 8.3% annually. And the policy response was fairly balanced: 3.4% of gross domestic product (GDP) was monetary stimulus, plus 4.9% of GDP fiscal stimulus.

These policies began a nearly 50-year inflationary cycle that culminated in the 1970s with a massive devaluation of the dollar and a de facto default on our national debt. The cycle included all the things history teaches us accompany big inflations: radical increases to government power, tax increases, war, wage and price controls, and the seizure of privately held property. When

I talk to most people about what actually happened during the big inflation of 20th century America, most people tell me that these things could have never happened here.

Well, like it or not... that's what *did* happen. And they're likely to happen again... except I expect the timeline to be compressed. I don't think it will take 40 years for inflation and its handmaidens – war, tax hikes, price controls, and the seizure of private property to destroy our currency. This time, it will happen much faster because our country enters this crisis on much weaker financial footing.

More about this in a moment...

First though... I'd like to talk about what happened to gold during this period. You're probably hearing more and more talk of a "bubble" in gold. The latest critic of gold is probably the most influential – Warren Buffett. He takes another crack at gold in his latest annual letter, segments from which were sent to me today ahead of their publication in *Fortune* magazine.

Is gold in a bubble?

During the last big inflationary cycle (1933-1981), the price of gold rose from \$20 an ounce in 1933, all the way to \$175 by 1975, when Americans were finally allowed to buy it again. That's a ninefold increase. And it is basically the same size of gold's advance from its lows in 2001 until today.

But of course, the inflation didn't stop in 1975. It actually continued to accelerate, with the biggest gains coming at the end of the cycle. Gold eventually reached \$800 per ounce – a 40-fold increase from its 1933 price.

Assuming a similar move in gold in this cycle, you would expect to see gold reach \$9,600 per ounce.

That may seem unrealistic to you. But I think it's a lock. It's not gold that's in a bubble. *The world's central banks and most of the West's sovereign bond markets are in a bubble.* Gold is just trying to warn us that what our leaders are doing is unsustainable and *extremely* dangerous.

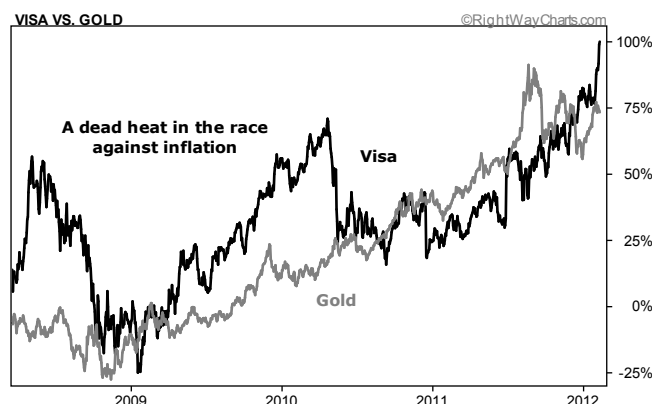
Let me show you a different and far more revealing way to look at the valuation of gold...

Visa owns the world's largest electronic payment network. It is truly one of the world's greatest businesses. Visa charges a toll for every dollar that passes through its network. (One of the biggest regrets out of my entire career was selling Visa, on a trailing stop loss basis, back in July 2010. Had we held the shares, we would now be up almost 100% since my initial recommendation in July 2009.)

As the world becomes more connected and modern, more and more people will use Visa's payment network. And as governments around the world print more money, the dollar volumes of Visa's network are sure to increase – simply because of inflation. *If you want to really know what's happening in the world in terms of inflation, all you have to do is read Visa's quarterly SEC filings.*

Its latest filing shows U.S. network volume is up almost 10% year over year, as of the third quarter of 2011. The U.S. is a mature market. That kind of growth can only be explained by a sustained inflation. And the rest of the world is up 28%. Yes, some of this growth is Visa reaching new customers in new markets, but most of it is simply the result of central banks printing money. Don't ignore these facts.

Now... let's consider the price of Visa's shares versus gold since Visa's shares began trading publicly almost five years ago. What does this chart tell you about whether or not gold is in a bubble?



What Gold Is Trying to Tell Us

Before we move on, we need to consider one more piece of the gold story... What happened to gold during the Great Depression tells me all I need to know about my government.

Many Americans don't remember (or were never taught) that all privately held gold bullion was confiscated in 1933. Yes, the government handed over \$20 for each ounce, but it wasn't a free exchange. It was forced on the threat of 10 years in prison. If a thief sticks a gun in your face and takes your wallet, does it matter if he gives you back a token of your former possession? Nope.

The confiscated gold – all of the privately held gold in the country – was then loaded onto 500 railroad cars and sent to Ft. Knox, which was built especially for the purpose of holding all this stolen gold. All this gold – or at least a lot of it – would eventually be sent overseas in exchange for debts owed by our government.

In the 1960s and 1970s, as our government's annual budget deficit soared, our foreign creditors (namely France and Spain) routinely demanded gold in exchange for dollars at the artificially fixed price of \$35 per ounce. Doing so made financial sense for them. On world markets, gold was trading for far more than \$35 – it was going for \$60-\$100 per ounce. By trying to hold the dollar against the artificial \$35 price, the U.S. ended up sending about two-thirds of our gold hoard – much of which had been stolen from private American citizens – to our overseas

creditors. Finally in 1971, Nixon simply defaulted on our promise by shutting the gold window forever.

Few people talk about this... but the actual impact of all these legal moves and foreign borrowing was that the U.S. government ended up taking its citizens' gold and giving it to European central banks. There are a lot of "new world order" conspiracy theorists out there, but I've never heard any of them talking about how nearly all of America's privately held gold was stolen and then shipped overseas during the 1960s and 1970s. It's not a theory or conjecture. It happened. Even so, I'd bet less than one American in 100 has ever figured this out.

Just think about how that would have made you feel... especially if you or your sons had fought in World War II. Americans risked their lives to save Europe from tyranny... only to see Europe's governments conspire with the federales to take our gold. If it wasn't true, nobody would have ever dared to make it up – it's too implausible. And yet... that's exactly what happened.

Why This Crisis Will be Worse Than the Great Depression

As I mentioned, in Buffett's upcoming annual letter, he rants against gold, saying, in effect, it's worthless and provides society with zero intrinsic value. It's hard to know if he really believes that's true... especially since his father understood the vital role of gold intimately. (You can read Congressman Howard Buffett's essay "Human Freedom Rests on Gold Redeemable Money" here: <http://www.fame.org/pdf/buffet3.pdf>.)

In any case, it's important to remember that before the Great Depression, our currency was still linked to gold and Americans owned more gold than any other nation in the world (until the federal government stole it from them...) Back in January 1933, citizens could exchange notes for gold at any Federal Reserve Bank. And America was still a net creditor to the world.

Why does this matter?

Because even though the 8.3% of GDP stimulus that was unleashed by President Franklin Delano Roosevelt in 1933 caused us to default on the gold standard, it did not destroy America's credit. We were still a wealthy nation – by far the wealthiest on Earth.

Watching the rise of the Nazis, the Communists, and hearing FDR's rhetoric about a "new deal," creditors decided to stop lending gold – to anyone. That shut down credit markets around the world, rendering the global banking system insolvent. (As I mentioned, our government responded by taking all the privately held gold in America and stashing it at Ft. Knox – the largest hoard of gold ever assembled in history.)

These facts offer an important lesson. Even though the Great Depression was the worst economic disaster we'd ever faced as a country, it didn't bankrupt us – in part, because our

government and our citizens kept their savings in gold.

This is one of the many advantages of gold that Buffett doesn't understand (or chooses to ignore). In a time of crisis, gold retains its value because it is the only universally accepted financial asset that *isn't* someone else's liability. Gold doesn't require the backing of any bank or government.

The problems we face today are much more serious.

What plagues the world's financial markets isn't the political rhetoric of Western leaders – it's their balance sheets.

Today, America is not only a net debtor to the world, it is the world's largest debtor. Most of you already know that the federal government's total outstanding debt exceeds \$15 trillion – not counting any future liabilities. Our government's debt is now certain to surpass our annual GDP in 2012. Keep in mind, detailed studies of government debt levels going back further than 100 years show that governments *never* repay debts in excess of 80% of GDP in sound money.

Obviously, that's a pretty big problem. But what isn't commonly understood is how these obligations also weigh against the total debt levels in the U.S. Americans also hold another \$15 billion in personal debt – things like credit cards, student loans, and car loans. Plus, there's state and local debts... corporate debts, etc. In total, counting up all of the debts we currently pay interest on, the total debt of the U.S. is around \$56 trillion.

The GDP of the entire world is only \$64 trillion. **Thus, our total debts are nearly 90% of the entire world's GDP.**

This, if nothing else, should tell you there's a huge problem with the U.S. economy and, by extension, the world's economy.

Buffett, along with just about every other important actor in modern finance, has apparently forgotten the critical role gold plays in free markets. *Gold insists, at all times and over all periods, on discipline and fairness between debtors and creditors.* In truly free markets, gold guarantees the viability and the integrity of every exchange. Without it, history shows, the corruption of paper money is inevitable, as is its collapse.

Ironically, Buffett seems aware of one of the main downsides to paper money – inflation. In his upcoming annual letter, he writes...

Even in the U.S., where the wish for a stable currency is strong, the dollar has fallen a staggering 86% in value since 1965, when I took over management of Berkshire. It takes no less than \$7 today to buy what \$1 did at that time.

Consequently, a tax-free institution would have needed 4.3% interest annually from bond investments over that period to simply maintain its purchasing power. Its managers would have been kidding themselves if they thought of any portion of that interest as "income."

For taxpaying investors like you and me, the picture has been far worse. During the same 47-year period, continuous rolling of U.S. Treasury bills produced 5.7% annually. That sounds satisfactory. But if an individual investor paid personal income taxes at a rate averaging 25%, this 5.7% return would have yielded nothing in the way of real income.

This investor's visible income tax would have stripped him of 1.4 points of the stated yield, and the invisible inflation tax would have devoured the remaining 4.3 points. It's noteworthy that the implicit inflation "tax" was more than triple the explicit income tax that our investor probably thought of as his main burden.

"In God We Trust" may be imprinted on our currency, but the hand that activates our government's printing press has been all too human.

It's not clear Buffett truly understands the other critical fault of paper money – the lack of a fundamental limit to credit creation.

The excesses of the world's current paper-dollar banking system could have never occurred under a gold standard. When societies base their banking system on gold, it's impossible for the amount of credit to so far exceed the reach of deposits. But without the discipline of gold reserve limits, credit always grows far faster than savings. It's simply part of human nature: It is much easier to borrow than to save.

As a result, credit inevitably grows faster – much faster – than savings. At some point, creditors realize they cannot be repaid because the burdens of the debt have become far too large to finance. The credit markets shut down – like they did in 2008. And the result is a massive inflation. It is the only way out: new money must be created to repay the bad debts.

This exact same saga has been replayed, time and again, in every paper money system ever devised in human history. As my friend Rick Rule likes to say: paper money's track record is unblemished by success. It always fails. And it always fails the same way – via runaway inflation caused by an effort to paper over bad debts.

You might not believe me about any of this... but this simple fact makes the point. For most of our nation's history, total debt in the U.S. rarely exceeded 100% of GDP. But just since 1971, after we left the gold standard, the amount we owe in total has soared, to nearly 400% of GDP. These debts were made possible by the paper money system. Without an "elastic" currency, debt this large could not have been created. The limited supply of gold reserves in the banking system would have restrained the expansion of debt.

It's really that simple. The gold standard keeps our bankers from doing incredibly stupid things. Without it, we are at their mercy.

We enter this next crisis owing more than we ever have before and without any fundamental limit to how much money we can print. That, my friends, is an incredibly dangerous combination.

Are my concerns overblown? Well, recall that a much smaller and more solvent U.S. government reacted to the Great Depression – 43 months of economic decline – with an 8.3% of GDP fiscal and monetary stimulus. Today's "Great Recession" lasted just over a year. The total decline in real GDP was about 1.8% – barely a blip on the radar.

But the amount of stimulus our government has thrown at the problem is unprecedented in American history – more than 30% of GDP. And the lion's share has come (and continues to come) in the form of new money.

What happens when a nearly bankrupt government goes on a wild spending spree, in response to a relatively minor economic downturn? We are about to find out. History doesn't offer a pretty picture.

What should you do to prepare? I have published reams of advice on this topic. Our three most important strategies are also the simplest: Make sure you own 10%-20% of your portfolio in gold and silver bullion. If you can, buy some foreign real estate, which doesn't have to be reported to the government. This will ensure you have money when you really need it (if the banks are closed) and someplace to go if America becomes unsafe.

I'm not saying that's likely to happen right away. But I do believe it will happen in the next 10 years. More Americans than ever before (more than 60 million) are completely dependent on the federal government. And the federal government is completely dependent on a printing press. Again, history suggests this won't have a happy ending.

One more thing about these troubling ideas... We are currently producing another video that's similar to the "End of America" video we made last year. This one is about China's plans to unseat the dollar as the world's reserve currency. It contains a lot of the information I published in last month's letter. I hope you'll watch it and, if you deem it worthwhile, share it with the folks you care about.

Now... about the third thing we recommend to protect yourself from the coming inflationary super-cycle...

It might surprise you... but I expect certain stocks will do very well during this period.

Yes, there will certainly be plenty of trouble along the way, like we saw in July 2010 and October 2011. But overall, I believe it's critical to shield some of your savings in stocks – especially in lieu of government bonds.

How to Buy the Most Capital-Efficient Stocks, Safely

Under today's conditions, therefore, I do not like currency-based investments [like government bonds]... My own preference – and you knew this was coming – is our third category: investment in productive assets, whether businesses, farms, or real estate. Ideally, these assets should have the ability in inflationary times to deliver output that will retain its purchasing-power value while requiring a minimum of new capital investment. – Warren Buffett, excerpted from his upcoming annual letter

Investing is a simple game.

The goal is to get the most in return for having given the least in exchange. Any serious study of this process will reveal just a few variables control the outcome.

First, the amount of capital employed is important. Thus, the cardinal rule is: *Don't lose money*. Money lost cannot be invested. Money lost will not compound.

Second, time matters. The duration an investment may be held continuously with dividends reinvested is critical.

And the third important factor is the rate of compound growth.

What's funny about this list is how simple the game really is... and how few people pay any attention to the most basic rules. I doubt many subscribers consider these variables before they buy a stock. What most people consider is simply, "Will this stock go up? By how much? And when should I sell?"

The questions they should be asking are almost the complete opposite.

They should try to figure out...

1. How fast are these shares likely to compound, assuming I reinvest all of the dividends?
2. How long will I be able to safely hold this company?
3. And most important, what's the most I can safely pay for this stock?

Given the limitations of my position, I share these ideas with a large amount of trepidation. These are not ideas that sell newsletters. You, gentle reader, expect me to deliver the name of a stock that will surely double in the next month, then double again next year. Believe me, if it were that easy, I'd oblige. But the truth is a bit more complicated...

There's one exception... one sure way to get rich. **And that is to buy capital-efficient businesses that have long-lived products and are capable of increasing payouts year after year.**

This approach is, without question, the best way to invest.

It's exactly the approach Buffett uses. But it's difficult to explain. Worst of all... once you understand how it works, it's just too simple. All you have to do is buy the kind of companies that excel at returning capital to their owners (the shareholders). Then you reinvest that capital. Rinse and repeat. It's not much harder than washing your hair.

And that means it's boring. For publishers, boring is the kiss of death. So please... forgive me. But the truth is, using this kind of a strategy over time will produce returns that *dwarf* the gains you're likely to make speculating, even if you're a great speculator.

Best of all, my approach, which is based on *capital efficiency*, is totally safe and requires almost zero effort. The whole trick lies in understanding which companies are capital-efficient and have good long-term prospects. Once you know that... you only buy when you can get the shares at such a low price that they essentially carry no risk.

These situations develop all the time. *One is available to you right now*. And I'll explain it to you in a minute. But first, I want to show this approach as it was implemented in real time, during one of the worst periods in the history of the stock market...

One of the Greatest Investments of My Career

Back in December 2007, I first recommended shares of **Hershey (NYSE: HSY)** – calling it “Our Best No Risk Opportunity Ever.” At the time, the stock was trading for around \$40. By the end of 2008 – after a huge bear market where the average stock fell by 50% – Hershey's shares had hardly budged. The stock was trading around \$35. We weren't stopped out.

By December 2009, two years after our original recommendation, the shares *still* hadn't budged. The stock was still trading for around \$40. Subscribers were irate. “When is this dog going to move higher?” they asked. Meanwhile, I knew that sooner or later, the shares would take off. I was convinced then – and I remain convinced now – this stock will be one of the greatest investments of my career. Why am I so certain?

Since January 2010, Hershey has been trending higher. Over the last two years, the share price is up 60%, versus the S&P's 20% return. Hershey recently hit my first price target of \$60. **More important to me, it continues to increase its dividends.** What did I see that the market (and some of our subscribers) missed?

Since 2005, Hershey had repurchased more than \$1 billion worth of its own stock – more than 10% of the company, in addition to paying large (\$200 million-plus) cash dividends. It has paid 325 quarterly dividends in a row – 81 years. It has increased its dividend payout every year since 1974. On a combined basis (dividends and buyback), the company pays out a remarkably large amount of the cash it produces. For example... in 2008, the company produced a little more than \$500 million in cash

from operations. It spent nearly \$300 million on dividends and share buybacks. (It also repaid \$128 million in debt.)

Hershey can afford to return so much capital to its shareholders because it requires little capital to grow. Over the last 15 years, the company's annual capital spending has remained essentially unchanged. In 1997, the firm invested \$172 million in property and equipment. By the end of 2010, its annual capital budget had only increased to \$179 million – essentially unchanged. Meanwhile, cash profits had reached nearly \$1 billion – growth of nearly 200%. This is the beauty of a capital-efficient business: *While sales and profits grow, capital investments don't.*

And that leads to the real secret – the most important investment secret you will ever be told. Some companies, like Hershey, can *increase the percentage* of their earnings they pay out as they grow. Let me make sure you understand this... The size of the payout Hershey makes to investors doesn't merely increase on a nominal basis along with sales... *It increases as a percentage of the company's gross profits.*

These payouts aren't linear. You have to be willing to wait five or 10 years to appreciate what the company is capable of paying out. For example, during the financial crisis of 2008 and 2009, Hershey's management retained capital to guarantee its competitive and financial position.

Now, with the company's cash and short-term investment balances in excess of \$2 billion and the company likely to earn \$1 billion in cash this year, I expect we'll see a major buyback soon. Assuming a similar-sized buyback to the one in 2006 (15% of sales), Hershey may pay out more than \$1 billion in buybacks and dividends in a single year. Again, remember... the timing of such a payout is uncertain. But it hardly matters because it's inevitable... In any case, the company just announced it would raise the dividend by 10%.

It's these payouts, which return cash to shareholders and increase the value of the stock by reducing the size of the float, that are the key to understanding the predictions I made when I first recommended the stock.

Here's what I wrote...

Let's assume that, thanks to share-count reduction, sales growth, and the company's incredible capital efficiency, it is able to increase the total amount of capital it returns to shareholders each year by 15%. The company currently pays out about \$500 million per year, on average, to shareholders. Ten years from now, growing that payout at 15% per year, it should pay out almost \$1.7 billion annually.

Today, the stock has a blended yield (cash dividend plus buyback) of about 5.5%. Assuming the yield falls in the future to, say, 3.5% as investors begin to appreciate the value of the company, the shares will be worth \$50 billion. Today, the total market value of all of the shares

outstanding is a little more than \$8 billion. Today's investor would make 525% in capital gains in 10 years, assuming he didn't reinvest the cash dividends (which would increase the return).

Lest you think my 15% growth rate number is too high, I generated it by comparing the actual annual increase in free cash flow per share from 1999 through 2007, which has been a little more than 15% annually. This number is tightly correlated to dividend and buyback amounts because it's the amount of money the company earns after all capital expenses have been paid and it reflects the compounding effect of the company's share repurchases.

Here's the part that's hard to get your head around... Thanks to the miracle of compounding, if this rate of growth continues over 20 years, investors should expect to make 20 times their money or capital gains in excess of 1,900%. Again, that's not including the impact of reinvesting the cash dividends, which would significantly increase returns.

There aren't many businesses that you can realistically expect to make you 20 times your money. There are even fewer businesses that you can expect to hold safely for 20 years. But in this case, you can. This company's leading product has remained totally unchanged for more than 100 years.

I don't have access to the company's detailed cash flow data for 2011 yet – it hasn't been published. But we do know several numbers, which give us a proxy for the real earnings numbers.

First, we know sales have risen substantially since our initial recommendation. Full-year sales in 2011 were greater than \$6 billion, roughly 20% more than in 2008. We also know that reported net income was more than \$600 million. Reported net income in 2008 was a little more than \$300 million – nearly 100% growth. We also know that Hershey normally charges \$200 million a year for depreciation and about \$100 million for liabilities... But these are noncash charges – accounting fictions, really. We'd estimate the company's actual cash earnings to be somewhere around \$800 million, up from \$500 million in 2008.

Assuming share count remains the same (and it hasn't – it's been reduced), Hershey is now earning 60% more per share than it did the first year we recommended it. The point is... with only good (not great) top-line growth, this company has been able to substantially increase its cash earnings per share. That's been done by expanding sales and increasing prices. And although the big share buyback we expected hasn't materialized yet, we are still up substantially on the stock.

Even better, as the company earns more, it will pay us more. The cash dividend this year will likely be around \$1.70 per share. Assuming you got the stock when it was trading around \$35 per share, you should earn almost 5% a year just sitting on the stock. That might not sound great... but it's a heck of a lot more than you would earn in 10-year government bonds.

Hershey has all the qualities you want in a real, long-term investment – which is why I've spent so much time going over the recommendation again with you. In fact, Hershey may be the best long-term investment in the world because it will never be sold to another company. This last point is *vastly* underappreciated by most investors...

I can't tell you how many times a great business I've owned or recommended has been purchased for a price that excited investors (because of a big short-term gain), but was bitterly disappointing for me because it meant our gains would no longer compound. A great example was when InBev purchased Anheuser-Busch in 2008. Most subscribers cheered because we got \$70 in cash for a stock we'd bought in the \$40s. But I mourned the loss of a company I knew would have never sold.

And that, to me, is the best thing about Hershey. It has a controlling shareholder – The Hershey Trust Company – that's literally not allowed to sell. Never. Milton Hershey established the trust to benefit the Milton Hershey School, which he created for disadvantaged children. The school educates underprivileged children and pays for their entire education, all the way through college.

Back in 2002, after listening to a bunch of investment bankers who were eager for deal fees, the trust decided it needed to "diversify" its endowment beyond the shares of only one stock, Hershey Co.

When you've got a business this good, anything else you buy is bound to be a disappointment. Clearly, the folks running the trust were about to make a big mistake. Luckily, the decision to sell so enraged the public in Pennsylvania, the state legislature passed a law requiring the trust to give advanced notice of any sale or merger that would result in the Hershey Trust no longer having complete voting control over Hershey Co. The law further provides specific authority for the attorney general to stop any transaction that isn't necessary to the future economic viability of Hershey Co.

If you're a long-term investor who's looking to cash in over many years by reinvesting dividends and watching the investment compound, having a controlling shareholder that's not allowed to sell is the perfect setup. The trust isn't allowed to sell, so it must focus exclusively on improving the results of Hershey – and increasing the payouts.

There's one other consideration... How much should you pay for a stock like this, or any other long-term investment? This ends up being the most important variable because the first rule of investing is

don't lose money. Remember... money you lose doesn't compound.

Here's an easy rule of thumb to use when trying to figure out a safe price to pay for a stock. Just figure out how much money it would take to buy back every share at the current market price and add in the total net debt of the company. The number you'll end up with is called *enterprise value*. That's the figure it would cost (in theory) for the company to buy itself.

Next, just figure out if there's any realistic way the company could afford to buy itself. Few companies actually go private this way... But bear with me. In Hershey's case, its enterprise value is currently \$15 billion. For the company to borrow this much money, it would have to afford roughly \$1 billion a year in interest payments (assuming 7% interest). That's more than its operating income... which means Hershey can't currently afford to buy itself.

On the other hand... when we first recommended the stock, its shares were about 50% cheaper, which put its enterprise value down around \$10 billion. Doing the same calculation leaves you with an annual interest bill of around \$700 million – something that was just inside the range of possibility back in 2009, when the company earned \$769 million from operations.

Doing this kind of analysis shows whether a company could realistically repay all of its debts and all of its shares. Assuming it can afford to do both, there's no fundamental difference between the risk of its stock and the risk in its bonds – because all the bonds and shares could be repurchased.

And that means on a fundamental basis, you're getting all the upside of the shares – all the upside of being an owner – with the same low risk of being a creditor. I call this buying at a "no-risk" price. There's no additional risk to buying the equity compared with the debt.

This is the best analysis to consider before you buy any stock – but especially one you're buying to hold for the long term. You have to make sure you will be comfortable enough to wait for the payoff. You have to make sure you've bought at a good, safe price.

While Hershey is just a tad too expensive right now to buy based on this analysis... you should watch the stock closely. Assuming shares pull back about 10% or so, it could again be purchased using our no-risk criteria. In this case, you'd have a situation where you are extremely unlikely to lose money that's likely to compound at about 15% year over the long term, and that you are extremely unlikely to ever have to sell. That's exactly the kind of situation you should be looking for, all the time.

It's the Best Way to Get Rich

Most people think Warren Buffett became the richest investor in history – and one of the richest men in the world – because he bought the right "cheap" stocks. And

legions of professional investors tell their clients they're "Dodd and Graham value investors... just like Warren Buffett." The truth of the matter is entirely different.

Until 1969, Buffett was a value investor, in the style of David Dodd and Benjamin Graham. That is, he bought stocks whose stock market capitalization was a fraction of their net assets. Buffett figured buying \$1 bills for a quarter wasn't a bad business. And it's not.

But it's not nearly as great of a business as investing in safe stocks that can compound their earnings *for decades*. Take shares of Coca-Cola, for example – they're the best example of Buffett's approach. Like my Hershey example, Buffett's Coke investment was based on capital efficiency.

Buffett bought his Coke stake between 1987 and 1989. It was a huge investment for him at the time, taking up about 60% of his portfolio. How could Buffett have known Coke would be a safe stock... and that it would turn into a great investment?

Well, like Einstein said famously about God, Buffett doesn't roll dice. He only buys sure things. He knew Coke's business model told him it was incredibly capital-efficient. And judging by its previous marketing results and its expansion into new markets, its sales would also continue growing. As Buffett would tell you, it wasn't that hard to figure out.

Later, other investors would bid up the shares to stupid levels. Coke was trading for more than 50 times earnings by 1998, for example. But Buffett never sold. It didn't matter to him how overvalued the shares were, as long as the company kept raising the dividend. In 2011, Coke paid out \$1.88 in dividends per share. Adjusted for splits and dividends already paid, Buffett paid \$3.75 per share for his stock in 1988.

Thus, Coke's annual dividend, 24 years later, now equals 50% of his total purchase price. Each year, he's earning 50% of that investment – whether the stock goes up, or down.

In his 1993 letter, Buffett wrote about his Coke investment and his approach – buying stable, capital-efficient companies with the intention of holding them forever so their compounding returns would make a fortune.

At Berkshire, we have no view of the future that dictates what businesses or industries we will enter. Indeed, we think it's usually poison for a corporate giant's shareholders if it embarks upon new ventures pursuant to some grand vision. We prefer instead to focus on the economic characteristics of businesses that we wish to own... Is it really so difficult to conclude that Coca-Cola and Gillette possess far less business risk over the long term than, say, any computer company or retailer? Worldwide, Coke sells about 44% of all soft drinks, and Gillette has more than a 60% share (in value) of the

blade market. Leaving aside chewing gum, in which Wrigley is dominant, I know of no other significant businesses in which the leading company has long enjoyed such global power... The might of their brand names, the attributes of their products, and the strength of their distribution systems give them an enormous competitive advantage, setting up a protective moat around their economic castles.

Buffett is looking for companies that produce high annual returns when measured against the company's asset base and require little additional capital. He is looking for a kind of financial magic – *companies that can earn excess returns without requiring excess capital*. He's looking for companies that seem to grow richer every year without demanding continuing investment. In short, the secret to Buffett's approach is buying companies that produce huge returns on tangible assets without large annual capital expenditures. He calls this attribute "economic goodwill." I call it "capital efficiency."

These kinds of returns shouldn't be possible in a rational, free market. Fortunately, people are not rational. They frequently pay absurdly high retail prices for products and services they love. Buffett explained how another of his holdings, See's Candy, earned such high rates of return on its capital in his 1983 annual letter, which I urge everyone to read. In explaining See's ability to consistently earn a high return on its assets (25% annually, without any leverage), Buffett wrote...

It was a combination of intangible assets, particularly a pervasive favorable reputation with consumers based upon countless pleasant experiences they have had with both product and personnel. Such a reputation creates a consumer franchise that allows the value of the product to the purchaser, rather than its production cost, to be the major determinant of selling price...

That's the whole magic. When a company can maintain its prices and profit margins because of the value placed on its product by the purchaser rather than its production cost... that business that can produce *excess* returns – returns that aren't explainable by rational economics. And those, my friend, are exactly the kind of companies you want to own.

And... you especially want to own these stocks during inflationary periods. As things get more and more expensive in the coming years, capital-efficient companies will have to buy less of them than other companies, on average. The result will be that inflation tends to lift their profits, rather than reduce them.

Now... if it were that simple, we'd all be rich. Buying these kinds of stocks is actually extremely difficult because you rarely get the opportunity to buy them at a reasonable price let alone a no-risk price.

Finding Capital-Efficient Stocks at a Great Price

That's why I urge you to make a list of these kinds of companies... to determine the price at which you can buy them on a no-risk basis... and then wait for your opportunity. Strive to buy the companies whose products and services you believe are most loved and most likely to be extremely long-lived. Try to acquire assets that your children's children will never want to sell. Set your family's wealth on the path of compounding. In time, you can join the Rockefellers – but only if you never sell.

I asked the analysts on my staff to make a list of the most capital-efficient companies in the world with market caps greater than \$1 billion. I specifically wanted to see companies that returned to investors a large percentage of gross margins over the last five years. I also sorted these companies based on current share prices, as I'm only interested in buying companies like these when I can get them on a no-risk basis, which generally means paying less than 10 times enterprise value... based on earnings before taxes, interest, and depreciation. As a shorthand, we call these "cash earnings."

Also, I'm only interested in buying truly great businesses, which in my book means that a company can earn a return equal to at least 10% of its assets. Therefore, I knocked all the stocks off the list that didn't have a return on assets of at least 10%.

Here's the list I came up with. These stocks are all tremendously capital-efficient. They all are great businesses. And they all are trading at (or close to) a safe price. The question is... which of these companies do you think you'll be able to hold the longest?

Short Name	Cap Eff.	ROA	P/E*
Applied Material	38%	12%	4.8
Diamond Offshore	44%	11%	5.5
KLA-Tencor	39%	15%	6.1
Symantec	42%	12%	6.8
Microsoft	40%	17%	7.3
Analog Devices	50%	14%	7.7
QLogic	61%	11%	8.1
Texas Instruments	46%	13%	9.3
Lancaster Colony	50%	14%	11
Xilinx	52%	10%	11.7
* P/E here is actually enterprise value/earnings before interest, taxes, and depreciation.			

For the most part, these companies are all involved in high-end technology, which makes their long-term futures difficult to assess. That's why Buffett doesn't buy tech stocks.

Then there's Diamond Offshore, which rents drilling rigs to the global oil industry. I'm tempted to recommend Diamond Offshore – mostly because 50% of the stock is owned by the Tisch family holding company, Loews Corp. I know Loews is extremely

well-managed. But... buying this stock raises two issues that are difficult to manage over the long term. First, the oil industry is deeply cyclical. If you want to buy this company, you probably have to wait until a major downturn. Oil at \$100 per barrel isn't the right time. Secondly, this company requires huge amounts of capital. Even though the Tisch family is great at making sure it gets paid for its capital, the competition will eventually make it difficult to maintain the incredible return on assets here.

There's only really one stock on my list this month that really jumps out at me. And that's **Microsoft (Nasdaq: MSFT)**. I know most investors have soured on the company because its products frequently stink and its share price has done nothing for more than a decade. On the other hand, I see a company that's masterful at marketing, whose software runs all of the world's biggest websites, and whose cash flow continues to grow at an outstanding pace.

Over the last three years, the company has returned almost \$40 billion to investors – or roughly 15% of the value of the entire company. Paying only seven years of cash earnings for a company like this seems awfully cheap.

I know... I know... Apple seems like the clear, runaway winner in the space. And maybe we're making a fool's bet here. But I believe both companies can continue to prosper in the computer space. Microsoft will surely continue to focus on serving its core enterprise customers, while milking its cash-cow Windows and Microsoft Office products. And Apple will continue to make brilliant consumer products.

I do believe Apple will begin paying a dividend this year... But I don't know if it will be enough to interest me in the stock. Most people don't realize... despite its success of the past decade it has yet to pay a penny to its owners – not a single penny. And the number of Apple shares outstanding increased 47% over the last decade, thanks to stock options. Apple is great at making computers. And it is great to its employees. Whether or not it will prove great to investors over the long run remains to be proven.

Action to take: Buy Microsoft (Nasdaq: MSFT) up to \$40. Using a 25% trailing stop loss, adjusted for the cash dividends we receive.

SIA Indicators

Looking at the money flow indicator (p. 11), you can see what I believe will prove to be a bottom in mutual-fund outflows from equity funds. I didn't think the outflows would reach the scale of the outflows we saw in 2008... And they didn't. I believe equity mutual funds will soon experience large inflows as the world's economy improves and people begin to move money away from bonds in anticipation of more inflation. **This indicator is bullish.**

The SIA Blacklist					
Short Name	Ticker	Market Cap	P/S	P/E	Total Return YTD
BIDU	Baidu	45,566,693,376	23.06	50.21	12.38
VMW	Vmware	39,773,499,392	10.52	56.41	13.25
AMT	American Tower	25,094,653,952	10.84	92.54	6.40
PSA	Public Storage	24,981,557,248	13.70	45.90	3.77
ISRG	Intuitive Surgical	19,355,076,608	10.96	39.99	6.24
HCP	HCP	17,330,997,248	10.03	27.60	3.83
ALXN	Alexion Pharmaceuticals	14,198,932,480	19.64	101.58	7.26
AVB	AvalonBay Communities	12,913,063,936	12.42	66.25	3.99

Likewise... our spread indicator is bullish. I warned you in October that interest rate spreads (between safe government bonds and risky emerging market bonds) were unlikely to widen as much as they did in 2008. I thought they'd reached a peak... and they did. Last week was the best issuance week ever for junk bonds, which suggests these spreads are now in a narrowing phase. **This indicator is extremely bullish for stocks.**

Finally... there are "only" eight companies on our Black List of overvalued stocks. All of these companies are well-managed firms with the potential for rapid future growth. While I suspect investors who pay 23 times sales for a \$45 billion company are destined to be disappointed (as is the case in Baidu), no indicator on our list shows clear irrational, speculative buying. When you see 10, 12, or 14 stocks on this list, it's time to be more cautious. But we aren't there yet. **This indicator is neutral.**

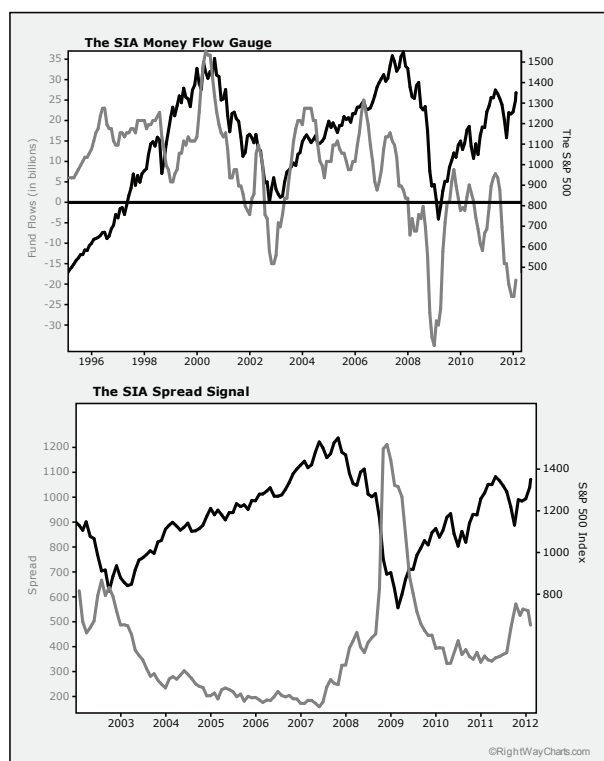
Portfolio Review

Besides the addition of Microsoft, there are no other major changes to the portfolio this month. I've moved some of our recommendations to a "hold" simply because their prices have increased and I don't consider the shares as attractive at these higher prices. Otherwise, all seems to be going quite well with our recommendations.

Regards,



Porter Stansberry
February 10, 2012



Stansberry's Investment Advisory Model Portfolio

Prices as of February 9, 2012

	Symbol	Ref. Date	Ref. Price	Recent Price	Dividends	Description	Action	Return*	Risk
"No Risk"									
Wal-Mart	WMT	09/09/10	\$51.91	\$61.96	\$1.76	World Dominator	Buy	22.8%	2
Johnson & Johnson	JNJ	07/06/06	\$60.52	\$64.89	\$10.46	World Dominator	Buy	24.5%	2
Exelon	EXC	10/09/02	\$21.47	\$40.05	\$15.72	Nuclear Power	Hold	159.8%	3
Hershey	HSY	12/06/07	\$40.55	\$59.79	\$5.04	World Dominator	Hold	59.9%	2
Microsoft	MSFT	NEW	NEW	\$30.77		Tech Giant	Buy NEW		2
The "Next Boom"									
ConocoPhillips	COP	04/02/09	\$41.45	\$71.55	\$6.23	Cheap Oil	Hold	87.7%	2
Calpine	CPN	05/13/10	\$13.93	\$15.39		Nat Gas Power	Hold	10.5%	2
Silver Wheaton	SLW	12/01/10	\$37.90	\$35.66	\$0.18	Silver Royalties	Buy	-5.4%	5
Monsanto	MON	11/18/10	\$59.63	\$78.33	\$1.44	Soaring Food	Hold	33.8%	5
San Juan Basin	SJT	01/07/10	\$18.34	\$18.50	\$3.24	Cheap Energy	Hold	18.6%	5
Dominion Res.	D	07/18/11	\$48.00	\$49.86	\$0.99	Export LNG	Buy	5.9%	2
Silver*	SLV	08/11/11	\$34.10	\$32.90		Inflation Hedge	Buy	-3.5%	2
Activision Blizzard	ATVI	10/13/2011	\$12.92	\$12.66		Gaming Publisher	Buy	-2.0%	2
Teekay LNG Partners	TGP	11/17/11	\$32.72	\$37.08	\$0.63	LNG Tankers	Buy	15.3%	3
Union Pacific	UNP	01/19/12	\$112.18	\$112.80		Trophy Railroad	Buy	0.6%	2
EOG Resources	EOG	01/19/12	\$105.08	\$112.45		U.S. Oil Exploration	Buy	7.0%	3
Cheasapeake Energy	CHK	01/19/12	\$20.68	\$22.34		U.S. Oil Exploration	Buy	8.0%	3
Gold Miners Fund	GDX	01/19/12	\$52.15	\$55.25		Gold Stocks	Buy	5.9%	4
Royal Gold	RGLD	01/19/12	\$67.51	\$70.29		Gold Royalty	Buy	4.1%	4
Victims									
iShares US Bond	TLT	1/19/2012	\$118.32	\$115.86	0.288793	Failing Currency	Sell Short	1.8%	5
*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.									

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