

3rd QUARTER MARKET COMMENTARY 2008

The last quarter has yielded some historic changes to the financial markets. We've seen number of significant and meaningful events unfold. As I write this, Congress is still hammering out the details of a complex plan designed to restore confidence in our markets. In light of all this "dislocation", there are a few important questions on every clients mind. Here they are with answers to each of them:

Question: What's really happening with all these banks and investment firms in simple terms, and how bad is it?

Answer: A number of "specialty banks" (investment and mortgage banks mainly) made some bad risk management decisions, and they are paying the price for it. In short, they either made or purchased mortgage loans which were not sound. Then, they leveraged them. Here's a simple analogy: Say you buy a cow for \$500. Then, you sell next year's milk from your cow to 25 people, who pay you in advance. You use all the advanced milk money to buy feed. Then, your cow gets sick. All 25 people demand their money back, and no one wants to buy your feed or a sick cow. That, in essence, is what's been occurring. These specialty banks (and in most cases not your local bank where your checking account is) made some very poor bets. In some instances it has led to their demise. And, it has extended to certain insurance companies who were willing to offer insurance against cows getting sick.

In terms of how bad it is, no one knows with any precision how many of the mortgage loans affected are actually good, sound loans and how many are not sound. The investment market hates this uncertainty, and we've been experiencing the result of that. It's worth noting that there is roughly \$10.5 trillion in total mortgage debt outstanding in the US, and about \$1 trillion are under the spotlight as sub-prime or "Alt A" loans.* Estimates of how many of these sub-prime loans are truly at risk of default range from 25% to 75%, but those estimates change daily.

Because these loans reside on the books of many of these financial institutions who have been unable to determine what they are actually worth, the free flow of capital, credit and loans – the lifeblood of our capital markets – has been restricted. At some point, this begins to affect businesses outside of the financial markets, which affects the overall health of our economy.

Question: Is this the end of the world as we know it?

As silly as the question seems, the palpable nervousness exhibited by many intelligent folks regarding the safety of their assets deserves a reasonable response. To be sure, this is a serious

problem. But, we're fairly sure the world will go on. It always has. The media loves a circus, and headlines portending the end of life as we know it have historically been proven wrong every single time. (Remember – the truth and the news are two different things.) We have faced challenges like this before. We'll probably face them again. And we seem to always recover and vault to new highs in terms of economic growth and prosperity. We see no reason to believe it will be different this time. A healthy dose of perspective can also be comforting. Allow me to zoom out for a moment:

Let's distinguish what is transpiring in the financial and housing sector from what is happening in the overall economy. While these two sectors have a meaningful impact on overall economic health, by no means do they represent the US economy as a whole. The best measure of the health of our economy is Gross Domestic Product, or GDP. It reflects *the total national output and income for our entire US economy*. If it's positive, it means the economy is growing. If it's negative, it means we are in a recession.

In the first quarter of this year, GDP grew at an annual rate of 0.9%. In the second quarter, it grew at an annual rate of 2.8%. ** This means that, despite the ills of the financial and housing sectors throughout this year and all the threats that "it's different this time", our overall economy continued to grow. And throughout history, economic growth has produced investment growth for patient investors who own diversified portfolios of quality investments.

The true threat to the overall economy is that the ills of the financial sector leach into other sectors and lead to lower growth rates or perhaps a decline in GDP. That's precisely the outcome that Congress and others are trying to avoid.

In terms of the safety and security of your various bank and investment accounts, there are many forms of insurance afforded to investors depending upon your specific circumstances. Call your bank if you have questions about your savings there. If you have concerns about the safety or security of your investment accounts, please call me. I'll be happy to discuss it with you.

Question: When will all this be over?

Answer: Soon, we all hope. Despite what opinions you may hold of the government intervening in these matters, a return to stable and liquid capital markets is necessary for the investment arena to get back to the business of creating wealth for investors. In our view, it is encouraging that the proposed "bailout package" is in fact not a bailout package. Should the government be successful in valuing, rehabilitating and redistributing these mortgage loans, the taxpayer will be a long term beneficiary in this process. Only time will tell. But, when stability does return, we would expect the investment markets to respond as they have historically by rewarding patient investors with higher values. Patience is the key here. Read pages 4 and 5 of the enclosed article, "The Power of Effective Diversification".

Question: What is the outlook for the short and long term as a result of all this mess?

As the various entities continue to work out details and assign value to these pools of assets, we would expect to see some continued short term fluctuation in markets. But recall that fluctuation *includes increases in value as well as decreases*. And, we do not know exactly when this will officially be “over” and the markets will turn their attention back to recovery and sustained growth. There’s always a reason for market declines and advances, and it’s no different this time. It’s worth noting the following:

Number of bear markets since 1948:	12
Average decline in the S&P 500:	-22.4%
Average length of bear market:	14 months
Number of bull markets following bear markets:	12
(Notice a pattern here?)	
Average length of bull market:	45 months
Average gain of the S&P 500 in bull markets following bear markets:	123%

Source: Investment News, Sept. 15th, 2008

As difficult as it can be to maintain your perspective in times such as these, history provides us with some powerful evidence to guide our decisions. It’s painful to witness declines in our portfolio values, but imagine the pain one might experience by deciding to sit on the sidelines in the hope of jumping back in when it was “over”, only to miss what has historically been greater wealth for those who maintained discipline throughout it all.

Question: What, if anything, should we be doing with our investment portfolios as a result?

Answer: Great question. You will recall that we initially developed your investment strategy based upon an assessment of your long term objectives and your risk tolerance for achieving those objectives. Also recall that we designed your strategy *expecting* to encounter both advances and declines over the long term. The current market environment provides an excellent opportunity to review your risk tolerance in light of your long term objectives and make any adjustments that may be necessary. As you review your quarterly statement, don’t hesitate to schedule a consultation if you would like to discuss this further and review your strategy and your risk tolerance.

If you are currently contributing to an investment or retirement account through payroll deduction or systematic deposit, we advise you to continue. You are making investments at a time when prices are lower. This is a good thing. Wealth gets created by buying when prices are lower.

In closing, I understand how discomfoting these times are to you. In addition to being your financial advisor, I'm an investor too. But I have confidence that the pillars of prudence, diversification, and quality will win out for all of us in the long run. Since history is on our side, you should have confidence too. Don't hesitate to call me if you'd like to talk in more detail. That's why we're here.

See you next quarter.

Jeff Helms, CFA

**Flow of Funds of the United States, March 8, 2008 Release, Z-1 Release, Debt Outstanding Tables, Federal Reserve Statistical Release, 6*

***Source: Bureau of Economic Analysis, 9/26/08*