

Celebrating Our Second Decade of Providing Unbiased Financial Advice

*"There are two kinds of forecasters:
those who don't know and those who
don't know they don't know"*

John Kenneth Galbraith

The Markets

Things have been changing so rapidly it is hard to write, produce and mail a newsletter without it being outdated before even the first step is completed.

A fundamental change to the financial system and the economy took hold in September. The credit markets went into cardiac arrest during the month with limited trading and there was a near run on money market funds. Bond prices on everything but US Treasuries suffered unusual declines. The stock market began to realize the impact of the deterioration in the already stressed lending markets and moved sharply lower.

The stocks of larger US companies as measured by the S&P 500 were down approximately 20% at the end of September while stocks of foreign companies fared even worse being down around 30%. Surprisingly, the stocks of smaller US companies did better with the Russell 2000 down approximately 11% year to date.

Trying to Make Sense of It All

What started out with the unwinding of the US housing bubble and losses on sub prime mortgages grew into a broad-based stampede from risk and a self-feeding destruction of asset values. The problems resulting from years of growth in the amount of debt relative to the size of the overall economy have now infected the global financial system. Financial

News Notes

We would like to thank everyone that attended the Autumn Seminar on Eldercare issues that was held at the Wellshire Inn on October 22. The event was well attended and we appreciate the presentation provided by Tammy Conover.

institutions, hedge funds and households are being forced to reduce debt (deleverage) at the same time, which is not only resulting in forced sales of investment assets, but is also reducing the amount of capital available to the credit markets.

It takes institutions with readily available capital to facilitate this process and there is only one type of institution that can help with a problem of this magnitude—governments. Governments around the world are now supplying the capital necessary to recapitalize financial institutions. The US has passed "TARP" (Troubled Asset Relief Program) to facilitate this process. The US government has also decided to follow the British, French, and other European governments in the more aggressive approach of investing directly in banks.

It is too early to tell if measures currently in place will be adequate or if further steps will be necessary. Risk taking will not suddenly surge and the credit freeze will thaw only gradually. It is our belief that global policy responses will succeed in pulling the markets back from the brink and that the credit markets will again function. The deleveraging process is finite and will come to an end when sufficient capital has been injected into the financial system to allow credit

to flow again.

Economies run on credit and the word "credit" is derived from the Latin credere: "to believe, entrust." The economy runs on trust, whether we trust that the people we loan money to will be able to pay us back or we trust that the people that buy goods and services from us will pay their bills. The world financial systems cannot function without trust and that trust has been damaged and will take time to repair, but the coordinated actions of government agencies around the world are designed to increase the confidence that investors need.

The Outlook

Up to this point the US economy has been very resilient, but the credit crisis will almost surely push the US economy into a recession as businesses and individuals are unable to get the capital they need to grow or operate their businesses. We expect that unemployment will continue to increase, but with slow or negative economic growth both inflation and interest rates will be low.

The same forces shaping the US economy will impact developed economies around the world. Developing economies are expected to continue to grow but at a slower pace than in recent years.

Given that the prices of equities have already taken into account a lot of bad news, weak economic data need not prevent the prices of equities from moving up. According to the “Bank Credit Analyst”, stocks typically bottom around six months before a recession ends. It is not inconceivable that we could be near the bottom of this market cycle.

Investment Strategy

We have been disappointed in the performance of our portfolios. In previous market downturns we have been able to add value by limiting exposure to overvalued asset classes and increasing exposure to assets that have been undervalued and whose value then recovers. The global deleveraging that is being experienced has resulted in the sell off of a wide range of asset classes, giving us “no place to hide”.

In addition to the overall environment, our portfolios have been hurt by fund specific issues. As an example, Loomis Sayles Bond Fund, run by the highly regarded Dan Fuss, mistimed the purchase of bonds of financial institutions and saw the value of those bonds fall.

During the quarter we arranged for the purchase of two-year Deutsche Bank notes; the performance of those notes is tied to the S&P 500 Index. Provisions of the notes include 10% downside protection and if the performance of the S&P 500 is positive over the two-year period we gain twice that performance with a cap of around 28%.

Other than the Deutsche Bank notes, we have not made significant changes to portfolios. The temptation to radically alter strategies or flee to cash during times like this is almost overwhelming. Investors that allow emotions to control their actions – selling when things are down and volatile and getting greedy and buying near market tops - are often penalized. There is no crystal ball but a Leuthold study of 22 past bear markets shows that when a recovery occurs it happens very quickly with maximum returns occurring in the first month of recovery and the majority of gains coming in the first year.

Your Assets at Schwab

It is important to note that client assets custodied at Schwab are not co-mingled with the assets of the company and if Schwab were to have financial problems or merge with another firm, client assets are separate. Even though there have been high profile failures – Bear Stearns and Lehman Brothers – clients have not lost assets. Shareholders and bondholders suffered but those holding assets at the firm did not, and it was not necessary for the SIPC to step in (see below).

Schwab is financially sound. As a registered broker dealer, Schwab is subject to the rules and regulations of the Security & Exchange Commission (SEC). The SEC has a “net capital” rule that speaks to the financial responsibilities of broker dealers. Simply put the net capital rule specifies the minimum amount of liquid capital a broker dealer is required to maintain to support firm and client activities. As of June 30, Schwab’s net capital was \$1.2 billion, which was \$948 million in excess of the required minimum.

An additional layer of protection is the Securities Investor Protection Corporation (SIPC). The SIPC does not insure the value of investments, but rather when needed, uses reserves to help satisfy claims against brokers in the event of a failed brokerage firm. After securities have been distributed, SIPC reserves are available to satisfy the remaining claims of each customer up to a maximum of \$500,000 for each account held in a separate capacity. In addition, Schwab purchases excess SIPC insurance from Lloyds of London.

Over the past several months we have spoken with many of you, and depending on your individual situation have encouraged you to continue with your financial strategy, believing that there will be a recovery and that staying invested will allow you to participate in the eventual recovery.

We expect that we will experience continued volatility and encourage you to get in touch with us as you have concerns or questions.

Portfolio Revisions and Comments

Those of you with taxable accounts may see increased activity in your accounts in the fourth quarter as we review holdings to harvest tax losses to offset possible year-end mutual fund distributions.

We are currently evaluating the replacement of a portion of the equity allocation with dedicated high yield bond exposure to take advantage of historically high yields.

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