

What a Difference a Year Makes - October 12, 2008

"These are the times that try men's souls." - Thomas Paine

Just one year ago this past Thursday, October 9, 2007, the Dow Jones Industrial Average closed at a record high of 14,164. Despite a rocky ride earlier that year, things looked promising for investors who had enjoyed an extended streak of prosperity and steady gains.

Friday, the Dow closed at 8,451, or 40% below the high it had reached just a year earlier. Global investment markets have experienced an unprecedented level of turmoil as credit and liquidity, not to mention investor trust and confidence, have evaporated and fear has gripped investors around the world. The past week alone earned the dubious distinction of being the worst in the 112 year history of the Dow. And Friday was the most volatile day (measured by intraday high to low) in those 112 years.

So what is being done to address this crisis, and what are we doing from an investment standpoint?

Recently passed rescue package

Congress recently passed, and the President immediately signed, the Emergency Economic and Stabilization Act of 2008. The final version of this rescue package includes many provisions, but the primary focus is to allow the government to purchase hard-to-value securities from banks and financial institutions in order to restore the stability and liquidity of those firms.

This is critically important, since without a buyer willing to purchase the bank's assets (loans), banks have been forced to sell them at fire sale prices. This forced liquidation not only hurts the bank that sells the assets, but it hurts other banks and financial institutions as they are forced to mark down the value of their own assets and to sell at further depressed values. As values continue to fall, institutions begin to hoard what capital they have and become increasingly hesitant to lend, credit markets dry up, and the economy (Main Street as well as Wall Street) comes to a screeching halt.

Since the government has the luxury of deep pockets and a long time horizon, it can hold these assets until investment markets stabilize and a fair value can be obtained. Although it is impossible to know what the future value of these assets will be, they will clearly have *some* value, and the actual cost absorbed by taxpayers should be much less than the \$700 billion figure that the rescue package authorizes. In fact, a number of experts (including Warren Buffett) believe that the government/taxpayer may eventually profit from these transactions if they are managed well.

The government's ability to purchase assets in order to establish a price floor and provide liquidity is absolutely critical, but it will take some time before the mechanisms required to enable this are in place. The government hopes to begin purchasing assets within a few weeks, which is extraordinarily fast, but it may not be fast enough for some firms.

An additional, and equally important, tool at the government's disposal is the ability to inject money directly into banks by purchasing equity in the banks now. Doing this provides the bank with immediate capital to shore up its finances without having to sell assets at depressed levels. In exchange for this capital, the government receives stock and becomes a passive investor in the bank with the intent of later selling the stock when markets have stabilized and prices have recovered.

While one might argue the appropriate scope of government's role in financial markets, there is no arguing that our government is taking decisive, creative, and unprecedented action. What is equally encouraging is that foreign governments and central banks are beginning to do the same, and have recently begun working in a concerted effort to do whatever is possible to manage what is clearly a global crisis.

What we are doing - short-term

I have always believed that one of the most important factors in investing is time horizon, and that money an investor needs within 5 years should not be invested in the stock market given its inherent volatility. Simply stated, one of the greatest risks an investor faces is being forced to sell at the wrong time (when values are depressed).

As a result of this core investment principal, our planning and portfolio structure includes a combination of money market funds and short-term bond funds that is equal to at least 5 years worth of projected distribution needs. In other words, our clients have some time to ride out a storm without being forced to sell into a stock market at depressed levels.

With the benefit of hindsight, I certainly wish that we had moved out of the stock market 6-12 months ago. Everyone does. However, absent the ability to foretell the future, I do not believe that selling now is prudent provided that each of the following is true:

- You have sufficient liquid assets (savings, money market funds, and short-term bond funds) to meet anticipated distributions over the next 5 years.
- Your planning objectives and time horizon have not changed, and your employment status remains stable.
- The current level of market volatility is not causing extreme anxiety of stress.

Please let me know if any of the above do not apply so that we can discuss alternative strategies that may be more appropriate, or that may provide additional peace of mind in these turbulent times.

What we are doing - longer term

I remain confident in the long-term survival and robustness of our economy, as well as that of global investment markets. While this is undeniably a difficult time, and investors are understandably nervous and uncomfortable, I do not believe that the current level of panic selling is prudent for long-term investors who risk missing an eventual recovery. For traders, speculators, and those with a short time horizon? Yes. For long-term investors? No.

As a result of this conviction, I am following our investment policies. This may mean recommendations to rebalance portfolios to their target allocations if we have exceeded threshold variances, which could result in the admittedly difficult suggestion to add to equity holdings that have become depressed. Obviously, any rebalancing change will only occur with your prior authorization, and suggestions will account for each client's situation and comfort level.

In addition to rebalancing, I am also considering modest refinements to the way portfolios are structured in general. The last few months have illustrated how interconnected global markets become during a crisis, and how the benefits of traditional diversification are often reduced right when they are needed the very most. We have been gradually increasing our allocation to alternative investments over the past year, and we expect to further increase these targets in the future (possibly by an additional 5-10% of total equity exposure).

What about my own investments?

Over the past few months, a few clients have asked how I invest my own money and what I have done differently, if anything, during this downturn. For those who are interested, I use the same allocation strategies and investment vehicles (primarily DFA and Vanguard mutual funds) that are used for client portfolios, and my assets are allocated 80% to stock mutual funds, and 20% to bond mutual funds.

Throughout the past year's downturn, we have invested regularly in my SEP IRA, my wife's 401k, and our daughter's 529 Plan. We have no intention to stop doing so simply because things are cheaper than they were a year ago. In addition to ongoing contributions, I have continued to rebalance our portfolio, which has often required an increase in equity (stock mutual funds).

I do not think that 80% equity exposure is right for everyone since my objectives, time horizon, and risk tolerance are unique to my family. However, I strongly believe that the underlying investment principals -- asset allocation, global diversification, low cost passively managed funds, disciplined rebalancing, and regular savings if possible -- remain appropriate for me and for my clients.

I hope that this information is helpful. Please do not hesitate to contact me if you have any questions about your investments or your financial plan. It is very important to me that you are comfortable with both, and I always encourage your feedback, comments, and suggestions.

Sincerely,

Bill Moeckel, CFA, CFP