

**“Managing Expectations”**

**Financial Market Update-** During the second quarter as the stock market rallied to new highs around the 14,000 level on the Dow Jones Industrial Average (DJIA) we cautioned investors to temper their enthusiasm because we felt that the market was overvalued and due for a correction of five to ten percent. After peaking in July, the stock market began to decline in early August briefly falling below 12,600 (10% below the previous market high) before closing at 12,800 on the DJIA on Thursday the August 16th. The stock sell-off was driven by fears regarding liquidity concerns which stemmed from the sub-prime mortgage woes that have been plaguing the financial sector. Since then the stock market has begun to rapidly recover reaching 14,100 when FED chairman Bernanke announced a ½% interest cut on September 19. This recent activity comes with a silver lining. The previous market low in February earlier this year occurred when the stock market reached a new high at the time of 12,700 and then adjusted to 12,200 before beginning its ascent to new highs in the 14000 range in July. The recent market low around 12,600 is around 400 points higher than the previous low. Monitoring the periodic lows of the market are a conservative way to measure the stock market's progress. Over the next few months, we feel the stock market is going to be in a choppy trading range. It would not surprise us if we had another correction of 500 to 600 points on the DJIA. **However, we feel the stock market is going to be slowly struggling higher toward the 15,000 to 16,000 level on the DJIA over the next few years.**

During the recent correction, some of our clients who recall the three year market decline from 2000 to 2002 have expressed concerns regarding the recent decline in stock prices. We have tried to settle these investors down by pointing out the following facts to them: **1.** A good portion of their investments returned over 20% in 2006. **2.** During the first half of 2007, many of their investments returned close to 10%. **3.** The recent correction caused investors to give back a portion of their returns from earlier in the year. Now that the stock market has recovered, year to date their portfolios have returned close to ten percent. They are not losing money. **4.** At the peak in March 2000, the very over valued stock market had an average P/E (price to earnings) ratio of around 26, recently the market has had an average PE ratio in the 17 to 18 range (a lower PE ratio indicates less risk). **5.** We feel the stock market has been over reacting to the sub-prime mortgage fears and the fallout it will have on the economy. Currently, it is a good time to be cautious in the stock market. **We are optimistic about the long term future prospects for both the economy and the financial markets.**

**“Perception vs. Reality”-** In his book **“the Intelligent Investor,”** Benjamin Graham, who is known as the grandfather of value investing and Warren Buffett's mentor, discusses investor behavioral psychology. When the stock **market is rising,** greed tempts investors to add to their stock investments. Even though the **market is becoming more expensive (PE ratios are increasing) and risky with every point it rises.** Conversely, when the **market is falling,** fear drives investors to think that they will be better off if they reduce the amount of stock they own. In reality, when stock prices decline, **PE**

**ratios are falling, risk is being reduced and stock prices are becoming more attractive.** This is a good time to be purchasing stocks not selling them. It is very important to fight the urge to panic and sell your stock investments when the stock market periodically declines. This will enable you to remain fully invested which will dramatically improve your chances of investment success over the long term. Stock market savvy investors embrace corrections in the stock market. **They view market declines as an opportunity to add to their portfolios at more attractive prices.**

**Our Advice on Managing Risk and Your Emotions-** We feel that it is very important for investors to avoid overweighting their feelings during times of stock market volatility. It is better for investors who are concerned about stock market volatility to focus on their long term investment objectives and their asset allocation guidelines. Instead of shifting assets in your portfolio as a reaction to stock market volatility, we feel investors should focus on a **disciplined risk management process** which:

**A. establishes** a comfortable bond/stock **target asset mix** and also sets allocation **triggers** (i.e. 40% bonds & cash, 60% stock, 5% **trigger**) and

**B. monitors** your asset allocation,

**C. re-balances** your asset allocation when the stock market drives it out of alignment (i.e. - if your stock allocation increases to 65%, this would trigger shifting 5% from: stocks, to: bonds & cash) and

**D. reviews the overlap of securities** in your portfolio and the **correlation of returns** of your investment funds and managers. We want to coordinate a group of funds that invest in asset classes that have low overlap (i.e.-portfolios that do not invest in the same securities) and whose returns are not directly correlated (i.e.- the funds do not move in the same direction at the same time).

This process will enable us to effectively manage risk. This risk management strategy forces you to sell high and buy low. Investor's who panic and attempt to time the market when it is declining, end up losing because they frequently sell out of the market when it is lower and invest back into it when it is higher. A better way to manage risk is to set an asset mix that meets your **return expectations** when the stock **market is rising** and addresses how much **downward movement** you are willing to **accept** when the market is **falling**. This approach focuses on utilizing your personal risk tolerance and comfort level to determine a bond/stock mix that is appropriate for you.

**Back to Basics-** Let's re-visit: A. the **Efficient Frontier** research on asset allocation: in his book "**Stocks for the Long Run**" Wharton Business School Professor Jeremy Siegel discusses the lowest risk mix of bonds & stocks over ten, twenty and thirty year holding periods from 1801 to 2000. The following are the results of his financial study:

<u>Holding Period</u>	<u>Lowest Risk Asset Mix</u>	<u>Ibbotson Chart</u>
10 Year	60% Bonds/40% Stocks	Point B
20 Year	40% Bonds/60% Stocks	Point D

**Comments:** The study concluded that the shorter your time horizon, the less risky bonds become, especially over a one to five year period. The longer your time horizon, the more risky bonds become. Over the 200 year study there were three twenty year periods when bonds underperformed inflation. There has never been a twenty year period when stocks underperformed inflation. For this reason, we encourage investors to invest as much of their assets in stocks as their comfort level will allow. Since retirees are likely to be receiving income distributions from their portfolio, we encourage these investors to invest a good portion of their stock allocation in **lower volatility, higher income producing stocks that have a history of dividend growth**. Research studies indicate that dividend growing stocks have provided significantly more return and less volatility than their non-dividend paying counterparts (Please review our Spring 2007 newsletter to view graphs and commentary that illustrate the benefits of dividend growth and the importance of limiting investment portfolio volatility during the income distribution phase. You can view our previously published newsletter in our corporate website at: [www.KrosnowskiandScott.com](http://www.KrosnowskiandScott.com)). Balancing stock investments with bonds enables investors to: generate income, reduce portfolio volatility, increase portfolio diversification and provide for growth potential to protect your assets against inflation.

#### **B. Ibbotson Asset Allocation research:**

**Comments:** **Benjamin Graham**, known in the investment world as the “Grandfather of Value Investing,” Warren Buffett’s mentor and author of the book the “Intelligent Investor,” encouraged stock investors to incorporate a “**margin of safety**” into their portfolios. He surmised that investors who were invested **100% in stock (Portfolio G)** would be more likely to panic and sell out of the market during periodic stock market declines. He felt that investors who invested **20% Bonds/80% Stocks (Portfolio F)** were more likely to remain fully invested for the long term, because the bond allocation dampened downside volatility. Ibbotson financial market research supports Graham’s investment philosophy. When comparing the risk/return characteristics of Portfolios F and E, **Portfolio F returned approximately ½% less per year with close to twenty percent less volatility**. We feel that portfolio E provides an attractive risk/reward trade-off versus portfolio F. Another informative comparison exhibited in the Ibbotson charts is the risk/reward trade-off between **Portfolios A (100% Bond) & C (50%Bond/50%Stock)**. **Portfolio C provided nearly 1.5% more annual return at a similar level of risk as Portfolio A**. This example illustrates the superior risk adjusted return (i.e. how much incremental return you receive with each incremental increase in risk) of portfolio C, as well as the **benefits of investing in different asset classes whose returns are not directly correlated with one another** (i.e. stocks and bonds do not move in the same direction at the same time).

**Comprehensively Serving Our Client's Wealth Management Needs-** We specialize in providing our clients with investment and retirement planning advice. We also provide free initial advice on the following:

- A. **Estate Planning-** We can help you become more familiar with will, trust and power of attorney documents as well introduce you to attorneys who can draft these documents for you (please feel free to visit the media section of our website to view an article that we had published in the **Washington Business Journal** titled "**Your Estate Cannot Wait.**")
- B. **Mortgage Planning-** We can review how long you plan to live in your residence and your attitude toward mortgage debt and advise you on how mortgage balance and what type of mortgage (i.e.- fifteen or thirty year conventional, interest only etc.) makes the most sense for you.
- C. **Life Insurance Planning-** We will review your existing policies to verify if you can reduce your policy expenses as well as verify what amount of insurance coverage is adequate to meet your needs. Over the past ten to fifteen years life expectancies have been increasing. This enables policy owners to exchange/upgrade their policies. This may enable you to maintain your current level of insurance coverage and lower your policy premiums or maintain your premiums and increase your amount of coverage.
- D. **College Education Planning-** We can advise you on investment fund selection for the VA 529 College Savings Plan managed by the American funds (one of our favorite fund managers) as well as other College 529 plan providers from other states.

**Conversion from Wells Fargo to Pershing-** On September 24<sup>th</sup>, First Allied Securities Inc., our broker/dealer, converted accounts held at Wells Fargo to Pershing. Pershing is an **affiliate of Bank of New York/Mellon Bank**. The company was founded in the 1930's and is the largest independent clearing firm in the United States. We would like to thank all of you for your patience as we work out the kinks and complete the transition. Administrative conversions are never fun, however, we feel that over time you will benefit from the enhanced services provided by Pershing.

**Client Profile-** We began working with Wilhelm & Doris Boeker in 1988 when we invested \$3000 in a tax free bond fund. Our relationship has grown as the value of the Boeker's assets have grown significantly. Born in Dortmund, Germany in the 1930's, the Boeker's survived World War II and immigrated to Northern Virginia in the early 1960's. Willie worked initially as an automotive mechanic and eventually founded his own company WB Motors. He sold the company and retired in the late 1990's. Willie religiously visits our office monthly. He and Doris enjoy traveling to Europe and taking vacation cruises in the Mediterranean. He is a rabid German League soccer fan and was a boxer in his younger days. My running joke with Willie is that he knocked out Max Schmelling before Joe Louis fought him.

**The Latest For Us-** Melissa and her family took advantage of her time share and spent their summer vacation in Maui in late July. During 4<sup>th</sup> of July week holiday lull

I toured Prague, Krakau and Auschwitz. The weather was cool and refreshing and the historic Eastern European buildings were beautiful. When I returned from Europe, I underwent neck disc fusion surgery to correct damage caused by high school and college football injuries on July 12<sup>th</sup>. The surgery and rehabilitation have gone extremely well.

We hope that you and your families are doing well as we approach the holiday season. Keep the faith!

Sincerely,

Andrew Krosnowski & Melissa Scott Paine