



Krosnowski & Scott LLC

Investment & Retirement Planning Specialists

Winter Financial Fitness Update- “Managing Bear Market Behavior” (March 2009)

2008 was a year to forget. Brought on by the financial devastation from sub-prime mortgage losses, the S&P 500 stock index plummeted over 40%. Some of our nation's most highly regarded financial institutions either failed (Lehman Brothers), had to be bailed out and taken over by the Federal government and white knight banks (as was the case with AIG, Wachovia which was absorbed by Wells Fargo, Merrill Lynch and Countrywide which are now part of Bank of America, and Bear Stearns and Washington Mutual which were bought out by JP Morgan). The financial tsunami spared almost no financial asset classes. Not only did stocks precipitously decline in value, real estate and corporate bonds prices were also negatively impacted. At some firms money market funds became temporarily insolvent (share prices which normally trade at \$1/share declined because a portion of the funds had exposure to sub-prime loans). Through fraudulent activities by unscrupulous financial advisers such as Stanford and Madoff (who are now in the process of being prosecuted) billions of dollars in investor's assets may have been embezzled. There is no wonder why investors currently have a lack of confidence in the financial system.

The crisis in the financial markets can be summarized as follows: **A.** During the 1990's certain liberal politicians and special interest groups pressured banks to lower the bar and pretty much do away with traditional lending standards so low income borrowers who would not normally qualify for a mortgage loan through asset and income verification would be able to receive mortgage loans. The primary entities that were used to facilitate this business activity were Freddie Mac and Fannie Mae. **B.** Mortgage and Wall Street investment banks miscalculated the inherent risk of these high risk loans using forecasting models that used more optimistic recent ten year economic data instead of more realistic economic over a thirty year period. This enabled them to justify participating in this type of business activity even though they did not take into consideration the effect of a severe economic down turn. **C.** During the period from around 2003 to 2006 conservative politicians did not do enough to regulate the activities of Freddie Mac and Fannie Mae and the bankers who conducted business practices that recklessly emphasized short term greed over sound business practices that would produce more stable, long term profitability. This activity included the excessive use of debt and participation in complex investments such as derivatives, CDO's and SIV's.

On the brighter side, fortunately for our clients, their assets are held and safe kept either at Pershing (which is a subsidiary of Bank of New York/Mellon bank) and the American Funds. Since both institutions are financially sound, neither has had to be aided by the Federal government or rescued by another bank. The money markets funds offered by these organizations have been unaffected by the turmoil in the financial sector.

The U.S. Treasury Department should get credit for urging Congress to authorize funding for a financial system rescue. This resulted in the approval of Treasury Secretary

Paulson's Troubled Asset Relief Program (TARP). Initially these funds were supposed to be used by the banks to improve their balance sheets which would revive the credit markets. This would stabilize the price of risky assets held by the banks. Better functioning credit markets would support the housing market with improved mortgage availability and pricing. Unfortunately, the situation was worse than expected. The banks needed more direct help to avoid major failures. As a result, the majority of the TARP funds that were distributed were used for cash injections instead of the purchase of risky assets.

Recently, the Federal government passed the nearly \$800 billion stimulus package. Unfortunately, according to some analysts approximately \$300 billion of this package provides no benefit to ordinary tax paying citizens. Much of this amount pertains to "pork" in the form of political payoffs to organizations, associations and social activist groups.

It has been our opinion that the best way for our government to stabilize the housing market is to work with banks in renegotiating mortgage contracts with borrowers. The first step would be to identify borrowers who are employed and who can realistically make their mortgage payments. This would weed out speculators and low income borrowers who never should have been able to purchase a home in the first place. This next step would entail taking such measures as extending the term of mortgages at risk of default and re-negotiating lower interest rates. If after providing these borrowers with subsidized financing if they do not meet their payment obligations then the properties should be immediately foreclosed upon.

The second issue that must be addressed is how to move toxic non-performing distressed assets from the balance sheets of banks to a separate entity. This would enable the banks to shore up their base of capital and enable them to be able to loan more money to borrowers. This would provide liquidity to the financial system, which may stimulate the economy and improve values in the stock market. The problem with this issue is how to value these assets. The government does not want to pay too high a price and the banks do not want receive too low a price. If the assets are valued too low it could have an adverse effect on the solvency of the banks. Once this issue is worked out, the non-performing assets would be moved into a "bad loan" bank. The government would create funds which would purchase bad loans and put money into them. Investment managers would invest capital into the funds and manage them. Investors such as pension funds would be able to participate in the funds. The funds could raise capital by selling government backed debt.

The Bottom Line- The financial markets are very uncertain right now. Nobody knows when the stock market is going to bottom out and slowly begin to recover. With the Dow Jones Industrial Average down over 50% in value from its' high nearly eighteen months ago, the last thing that we want any of our clients to do is to sell while the stock market is at such a low level. To try to quantify how difficult that things are right now one only needs to know that even the greatest investors such as Warren Buffett (who recently declared that he some investment decisions in 2008 and whose company declared a loss for the first time since 1965) have been negatively impacted by the massive decline that we have experienced in the stock market over the past fifteen months. We continue to encourage clients to stay the course and reinvest their quarterly dividends as much as

their comfort level will allow. This strategy known as dollar cost averaging enables investors to purchase more shares while the stock market is low and reduces the average cost of their shares. We feel that investors who do this over the next five to ten years may come out way ahead of where they were a few years ago.* **For our clients (especially those who are retired and receiving income distributions from their IRA's) our main goal is to stay in close contact with them and to assist them in making adjustments to their investment portfolio if they are not comfortable riding out this financial storm.** If you have cash, it is our opinion that right now may be an opportunity of a lifetime to invest in companies that are currently trading at very low stock valuations that we may not see again for a very long time. According to Global Financial Data, Inc., when reviewing rolling stock market ten-year average annual returns, as of 12/31/2008 we hit the lowest level ever since 1810 including the ten year period from 1931 to 1940 which accounted for the Great Depression. The approximate ten year average annual returns for the periods ended 12/31/40 and 12/31/08 were -1.3% and -1.5% respectively. **Looking back to every point when the market returned 2.5% or less for 10 years, it then returned an average 13.3% for the next 10 years with a range of 7.1% to 18.6%.****

During the last 17 bear markets since 1930, the stock market averaged 45% return during the following 12 months once it reached bottom. Two other points to consider are **quarterly fund cash flows** and **investor sentiment**. According to Strategic Insight, during the 3rd quarter 2002 there were extremely high redemptions around the time that the stock market had bottomed in October. Shortly thereafter there were record fund inflows during the 1st quarter 2004, however the stock market had already advanced over 36% in 2003. A recent survey by the Conference Board, a research organization best known for its consumer confidence index, found that Americans were recently more bearish than they have been since 1987. In the past, there have been only six surveys when the proportion of bears reached 36% or more. **Five of those times were followed by double-digit advances in the S&P 500 during the subsequent 12 months.****

How To Cope With Financial Stress- In the February 2009 edition of Kiplinger's Personal Finance magazine Laura Cohn wrote an article titled "What You Need to know About Financial Stress." The following is a thumb nail sketch of the article: **1. This Too Will Pass**- it is important to talk things out, express yourself and hear the point of views of other people, **2. Work It Off**- exercise will help relax and calm you down, **3. Take A News Break**- turn off your TV and radio, and recognize that headlines are just fragments of the bigger picture. Headlines are a lagging not a leading indicator. **4. Curb Your Spending**- Cut out non-necessity purchases, **5. Unplug And Play**- turn off the computer and the video games and spend time on inexpensive activities such as hosting a potluck dinner for friends. Play re-connects you with friends, in the end relationships are more important than money. **Summary**- To cope with a shrinking portfolio, we suggest that you set spending priorities, tune out the noise and keep your cool.

Since things have been so very difficult and volatile in the financial markets we will continue to try send you briefer monthly updates. Hopefully when things settle down, we will get back to sharing more in depth quarterly newsletters with you.

We hope that you and your family are in good health and good spirits. Things in the economy and the financial markets are going to eventually get better. The reality is that

our challenge is all about time. It is going to take time for; the banks to clean up the sub-prime mortgage mess, the government to manage and turnaround the “bad bank” loan assets and the stimulus package to have a positive effect on the economy. We wish we could let you know exactly when this will happen but unfortunately we cannot. Have courage! We have been here before- and we’ve survived and prospered. It is our understanding that there is close \$8 Trillion in cash equivalents on the sidelines waiting to go back into stock and fixed income investments.

We are extremely grateful for the patience that you have exercised and the support that you have provided to us. Thank You!!! Hang in there and keep the faith!

Sincerely,

Andrew Krosnowski & Melissa Scott

PS- Value Investing- The logic behind a long term strategy can be traced to the investment philosophy of Benjamin Graham, who is known as the “Grandfather of Value investing” and was a mentor to Warren Buffett. He believed that when the stock market is rising that it becomes more risky and expensive in price and therefore has much more room to decline in value. Conversely, he felt that as the stock market declines in value it becomes less risky and expensive and has less room to fall in value.

Market Cycles/Investment Clock/Behaviorial Psychology- Graham’s value strategy is consistent with the investment clock concept. On the clock, at 12 o’clock the stock market is at the highest level, moving from 1 o’clock the stock market is declining toward the lowest level at 6 o’clock, from 6 o’clock the stock market is rising in value back toward 12 o’clock. Unfortunately, many investors invest around 12 o’clock when the investment environment is optimistic and the stock market is “**high**” and they sell around 6 o’clock when there is pessimism and the stock market is “**low.**” Historically, even though it is tough to go against the herd when economic conditions are difficult, successful investors hold when the stock market is declining and add to their positions when the stock market is low. This strategy requires discipline to go against your psychological survival instincts to seek safety when you feel fearful. To sum up this concept, “it is about time- not timing the stock market.”

“Some people say they want to wait for a clearer view of the future. But when the future is again clear, the present bargains will have vanished. In fact, does anyone think that today’s prices will prevail once full confidence has been restored?”

That comment was made 76 years ago by Dean Witter in May of 1932-only a few weeks before the end of the worst bear market in history.

*Dollar cost averaging does not assure a profit and does not protect against a loss in declining markets. This type of investment program involves continuous investment in securities regardless of fluctuating price levels of such securities. Investors should consider their financial ability to continue their purchases through periods of low price levels.

** Of course, historical results are not predictive of future returns.