

## MARKET UPDATE

*Fall, 2008*

— *Russell B. Dow, J.D.*  
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Dear Client:

It is said that the current financial crisis is a “once in a 100-year” event. In better timed and better enjoyed lives, we might have been born too late and have died too early to have witnessed such a rarity.

Today we are seeing the ominous progression of a pandemic, one which began by infecting a few obscure Bear Sterns hedge funds in the summer of 2007. Like a virus taking foothold in a population, the contagion spread to domestic investment banks, then retail banks, mortgage companies, insurance companies, and now foreign financial systems. Most recently, the fever threatens the solvency of emerging nations—Iceland, Hungary, and Ukraine, in particular. That was Round One.

Round Two is a growing list of non-financial company casualties. In a very real sense, the problems on Wall Street have cascaded onto Main Street leaving workers without jobs—or in fear of losing their jobs. Not surprisingly, then, the Consumer Confidence Index hit an historic low since that index’s 1967 inception. By that measure, consumers are more pessimistic today than they have been at any other time during the past four decades, including even the economic malaise of the 1970s.

This dour sentiment is reflected in—and driven partially by—the stock market collapse. Just days ago, U.S. stocks were *lower* than they were in the summer of 1997. To give that period some perspective: It was only in 1993 that the World Wide Web was made available free for public use. In 1997, Microsoft Windows 95 was the dominate operating system, broadband became available for the home market, and Google was still a year away. You may well not have used e-mail or had a cell phone. What the stock market is saying is that our economy is worth no more today than what it was worth over a decade ago. That is sobering to contemplate and, I think, probably not true.

Another figure with which to grapple: The recent market decline was the second largest since the Great Depression year of 1931—and, in fact, the second largest since 1825 (183 years ago).

If we can find solace in negative numbers, it may be in the fact that the U.S. market has been less hostile a place than most every other part of the world, as indicated in the following table:

Country	Index	Declines From All-Time Highs Through 10-28-08
Japan	Nikkei 225	-80%
Russia	RTSI Index	-74%
China	Shanghai Composite	-72%
Vienna	Austrian Traded Index	-63%
Netherlands	Amsterdam General	-61%
Hong Kong	Hang Seng	-60%
Taiwan	Taiwan Cap Weighted	-58%
India	BSE 30	-57%
Singapore	Straits Times Index	-57%
Sweden	Stockholm Gen Index	-55%
Paris	CAC 40	-55%
Italy	Milan	-54%
Brazil	Bovespa	-54%
South Korea	Seoul Composite	-54%
Spain	Madrid SE Gen Index	-47%
Australia	All Ordinaries	-45%
London	FTSE 100	-44%
Germany	DAX	-41%
<b>USA</b>	<b>S&amp;P 500 Composite</b>	<b>-40%</b>
Switzerland	Swiss Market Index	-39%
New Zealand	New Zealand Stk Ex	-37%

### *The High Costs & Ineffectiveness of Global Diversification*

Much of Wall Street sells fads. Over the past several years, investors were sold on the apparent diversification virtues of emerging markets and foreign stock investing.

Unfortunately, many investors, often at the advice of their advisors, infused their portfolios with foreign securities without regard to the quality of the holdings. Worse yet, as recent market behavior has demonstrated, global markets are, perhaps, more interdependent today than in earlier times, not less.

Effectively, investors in foreign stocks have paid a high price for portfolio 'insurance' that ultimately did not work.

Even worse still: Many foreign currencies have depreciated substantially against the dollar. That devaluation has resulted in some U.S. investors with foreign stock portfolios confronting another 20% to 35% dollar loss, in addition to the market declines already incurred.

### *An Analogous Period*

As of November 6, the Dow Jones Industrial Average was down 39% from its 2007 high; the banking system is under intense strain; and FDIC coverage of individual bank accounts has been increased temporarily from \$100,000 to \$250,000.

In December of 1974, the DJIA was down 45% from its 1973 high, there was great concern over the viability of the banking system, but FDIC coverage of individual bank accounts was not increased.

The banking system did not collapse in the 1970s and, by the end of January 1975, the DJIA had risen 22% above its December 1974 low; by the end of March 1975 the index was up 33%; and by the end of 1976, it was up 74% above its 1974 low.

To survey the landscape of failed banks, investment firms, insurance companies, collapsing currencies, and now closed factories, one might guess that we were in the midst of a war. But the explosions—or, rather, implosions—have ripped through the world economies with no more sound than the clicks of computer mice. The root of the crisis is merely two dimensional and exists wholly on computer screens.

The hope, then, is that the problem may be more readily addressed than if the world were grappling with a crisis on the human scale such as war, disease, or natural disaster.

### LESSONS RE-LEARNED

The sad commentary on the current turmoil is that Wall Street should have learned its lessons numerous times before, and as recently as during the high-technology bubble burst of 2000-02. The first lesson from that episode is that sometimes *all junk securities* go bad *at the same time*.

Hence, a broadly diversified portfolio of *low-quality* securities does not equate to a broadly diversified portfolio of *high-quality* securities. Diversification is not an antidote to an irreversible setback.

However, during the run-up to the current crisis, the prevailing thesis among investment bankers was that diversified portfolios of sub-prime mortgage-backed securities were safe, conservative, and appropriate for ownership

by banks, pension funds, insurance companies, and for the average individual investor typically through funds.

Similarly, investors were sold foreign stocks, without regard to their quality, on the premise that the diversification element would provide portfolio protection.

The second lesson demonstrated again is the inability of anyone reliably to time the financial markets. Therefore, if one accepts that market changes cannot be predicted, it is imperative to own predominantly high-quality assets *at all times*.

The best re-affirming evidence of the futility of market timing is the recent failure of so many investment firms and hedge funds. With their former hundreds of billions of dollars of combined market value, these companies were able to employ the best minds in the field and build the most comprehensive mathematical models. Still, all that collective wisdom failed to see or prepare for the storm that was brewing, and nearly *en masse*, even the oldest, largest, and most prominent of these venerated institutions failed.

That said, there is always someone whose prognostications prove to have been uncannily accurate. In this regard, a formerly little known New York University economist, Nouriel Roubini, has reached star status. His website RGE Monitor ([www.rgemonitor.com](http://www.rgemonitor.com)) provides in-depth coverage of developments

worldwide and is worth a look—but I warn you that Professor Roubini’s continuing dire predictions can read somewhat like a Stephen King novel.

### WHERE TO HIDE?

The financial crisis is so extensive that investors are legitimately tossing earlier notions of what qualify as “safe” investments.

To comment on a few:

#### Bank Deposits

FDIC-insured bank deposits of a failed bank are subject to the solvency of FDIC, and that agency’s viability is not assured. A large bank collapse would likely deplete FDIC’s assets, thereby throwing the ball to Congress to become the white knight. It is troubling to consider that just one failure could put FDIC under water. Had Washington Mutual required a bailout when it failed recently, that single event would have consumed half of FDIC’s assets. It seems likely that, at least for political reasons, Congress would come to the rescue of depositors. However, lingering doubts among investors explain why one-year risk-free U.S. Treasury securities yield less than half that of many one-year bank CDs. Furthermore, it is doubtful that bank deposits in excess of FDIC insurance would be protected under any circumstance. With over 100 U.S. banks already on the FDIC’s watch list for potential failure during this crisis, it

would be imprudent to exceed the FDIC insurance limits.

#### Cash Held By Insurance Companies

Some people have cash held by life insurance companies, either in the form of life insurance with cash values or fixed-rate deferred annuities. Many states have guarantee funds which may provide some protection, should a life insurance company fail. The limits on such insurance vary from state to state, but most such guarantee funds cap liability to \$100,000 in cash value. We also do not know what action a state might take (or could financially afford to take) if its insurance guarantee fund were depleted.

It is most important to recognize that such deposits are not covered by Federal Deposit Insurance. Hence, if we might not feel comfortable having our cash in a bank that does not carry FDIC insurance, we, also, might not be comfortable with our cash in an insurance company, since it cannot be FDIC-insured.

As the financial crisis has evolved, the “guaranteed” aspect of annuities and cash value life insurance products is now suspect, as many life insurers worldwide have fallen in desperate need of lifelines themselves. If U.S. Government bailouts are forthcoming, it is thought they will be offered only to those insurance companies (1) for which survival is crucial to the economy and (2) for which a lifeline would actually be effective. In other

words, if an insurance company is not deemed essential or if it is beyond help, then the insurer and its policyholders probably should not expect federal assistance.

The depth of concern over the ability of insurance companies to meet their obligations in the coming months is evidenced by the depth of the declines in their common stocks, from their 52-week highs to their recent lows. As examples, Hartford Financial fell -92%; Lincoln National, -79%; Manulife, -64%; MetLife, -63%; Protective Life, -84%; and Prudential, -77%.

### Money Market Funds

The Reserve Primary Fund, the nation's oldest and largest money market fund, fell below \$1 per share in September, making it only the second money market fund in history to "break the buck." The case of the Reserve Primary Fund illustrates the desirability of having a large financial institution behind a money market fund that may be expected to make up any shortfalls in its funds. In most instances where a money market fund sponsored by a large financial institution is in danger of passing on losses to its shareholders, the fund's parent has made up the shortfalls and so shareholders have incurred no losses.

On September 19, 2008, in an effort to stabilize the markets, the U. S. Treasury announced that it would make available \$50 billion to guarantee "temporarily" about

\$2 trillion of the \$3.4 trillion in money market funds.

Of note for our clients with Pershing's (Bank of New York) Dreyfus money market funds, Dreyfus fulfilled the requirements for obtaining insurance under the Treasury Guarantee Program for all money market fund portfolios, and as of October 27, 2008, the U.S. Treasury Department had executed each Guarantee Agreement with the funds under the Program. Each fund is covered under the program until December 18, 2008.<sup>1</sup>

### U.S. Government Treasury Securities

If we are looking for absolute risk-free investments, the closest we shall probably ever come are U.S. Government Treasury securities. These securities are legal obligations of the government, not merely "moral obligations" such as a potential bailout of FDIC. Therefore, they are backed by the full taxing power of the U.S. Government. Even more significantly, the U.S. Government has the unique ability to print money to pay its bills. Consequently, even under a worst-case scenario, holders of U.S. debt almost surely would be repaid, even if in the form of deflated dollars.

<sup>1</sup> The U.S. Treasury Temporary Guarantee Program for Money Market Funds became effective as of September 19, 2008 and is in place for an initial 3-month term, through December 18, 2008. The Program may be extended, solely at the Treasury's discretion, but only up to September 18, 2009, and the Funds' potential continuing participation in the Program would be subject to (a) the Program's being extended; (b) the Funds' renewal of its coverage; and (c) payment of any applicable fee. The Program covers shares owned as of September 19, 2008 in a covered fund. Any decrease in the number of shares owned after that date would extend coverage only to the value of those shares.

**RISKS TO THE ECONOMY  
& THEIR CONSEQUENCES TO INVESTORS**

Our economy faces two major risks. The first is the possibility of a severe recession. The second is an acceleration of inflation. Economic decline and inflation are concerns at all times. Today, however, the potential for rapid and extreme change appears to be more significant than ever.

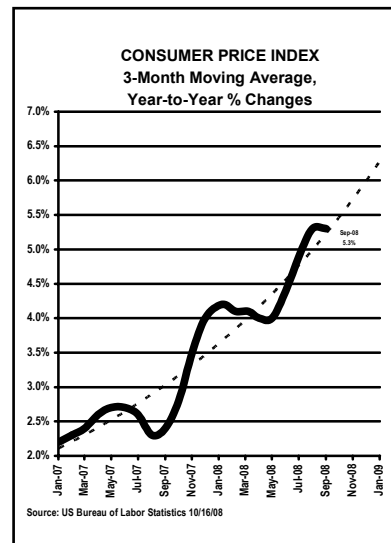
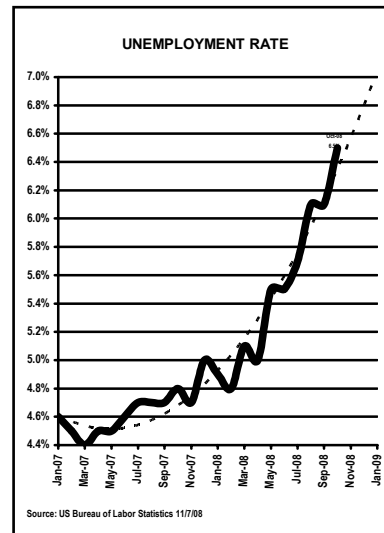
Consequences of the risks:

- A severe recession could cause investor *loss of principal* as poorly capitalized companies and borrowers fail. This would include insurance companies and banks.
- Accelerating inflation would cause investor *loss of purchasing power* for those who hold cash and bonds.

Both such portfolio losses should be considered to be permanent in nature and, therefore, critical to avoid. If we suffer a loss due to the insolvency of the company we own (or the bankruptcy of an uninsured debtor), we cannot expect to recover when the economy recovers. As well, periods of inflation are rarely followed by periods of deflation, making purchasing power losses most always permanent.

Through the unemployment rate and the consumer price index, the following charts help illustrate the rapid rates at which the

business climate has deteriorated and inflation has accelerated over just the past 12 months:



Underscoring the magnitude of the economic problem: The nation's unemployment rate rose to a 14-year high of 6.5 percent in October as another 240,000 jobs were cut. A recent news headline reads, "GM's US sales plunge 45%, Ford down 30%; Industry could have worst month in 25 years."

Our two-dimensional computer screen crisis has clearly migrated to the real world.

Professor Roubini writes,

The global economy is already headed towards a global recession as advanced economies are all in a recession and the U.S. contraction is now dramatically accelerating. The first engine of global growth – the U.S. on the consumption side – has now already shut down. The second engine of global growth – China on the production side – is also on its way to stalling. Thus, with the two main engines of global growth now in serious trouble, a global hard landing is now almost a certainty. ... So brace yourself for an ugly and protracted global economic contraction in 2009.

While Mr. Roubini may overemphasize the negative case, we cannot afford to ignore the potential of the problem.

In the short-term, the inflation risk may be subsiding. In the words of Dallas Federal Reserve President Richard Fisher, the inflation threat has “vaporized.” That might be more comforting if economists had been more right recently. As well, the admission that the inflation threat has suddenly vanished illustrates just how quickly—and unexpectedly—the world can change. Therefore, we still must prepare for the possibility that inflation may not actually have subsided or that it may suddenly rear its head again. Inflation has been a perennial problem throughout world economies, and the U.S. has not been immune from its reach.

Even accepting the possibility of low near-term inflation, when this current crisis subsides, it is thought by some that inflation may take off with a bang. The Federal Reserve has dropped the Federal Funds rate to

just 1%, a dramatic change from the 5.25% rate before onset of the crisis. Although this stimulative effect can be powerful and highly inflationary, traditionally the Fed has been slow to raise rates during a recovery for fear of derailing the economy again. As well, Congress is already at work preparing a \$150 billion stimulus package to follow the \$700 billion bailout package of a few weeks ago. The fantastic size and multitude of the governmental intervention and stimulus programs enormously heightens the risk that the economy could go into overdrive with quickly escalating prices.

Because inflation, until recently, had been so low for so long, it is easy to discount the damage it can inflict on an unprepared investment portfolio. History gives us reason for caution: For the five high-inflation years ended in 1981, the annual inflation rate reached a peak of 14.8% and averaged 10.1%, wiping out 41% of a dollar’s former value. In other words, \$500,000 in 1977 was effectively worth just \$295,000 five years later using constant dollars. Or, to put it another way, an investor needed 62% more money (\$809,000) after the period, just to have stayed even.

### PORTFOLIO PROTECTION

No one can tell us *if* we will have higher inflation or *if* the business contraction will be long or deep. Therefore, we must be prepared for *both* possibilities.

## Preparing for Inflation

The solution to the inflation problem is simple—we must own something.

Specifically, we must own something for which the *replacement cost* increases *because* of inflation. When dealing with financial assets, that ‘something’ is common stock.

Through stocks, we own factories, business infrastructure, intellectual property such as patents and copyrights, and brand name recognition—all assets that can be expected to appreciate with inflation because, after a period of inflation, they would cost more to recreate.

In contrast, those who hold cash or bonds may discover that these paper notes are of fleeting value.

## Preparing for a Recession

If common stocks help mitigate inflationary risk, what happens if we have a recession?

For all the good that they might do for us against a rising tide of inflation, stocks expose us to the potential of permanent capital loss, particularly during an economic contraction.

To help minimize that possibility, it is our strong belief that our portfolios must adhere to two important rules:

1. Strong Balance Sheets: The first rule is to own predominantly high quality securities, whether we own stocks or bonds. The easiest way to identify the quality of a security is to look at its Standard & Poor’s ranking. For a stock, if that ranking is an A+, A, or A-, then it is probably a high quality issue. Such companies tend to have especially strong balance sheets.

To assess the quality of a portfolio of stocks, we have devised what we refer to as the “Portfolio Quality Index” (PQI). By definition, a portfolio of “average” quality stocks would have a PQI of about 50%. In an effort to protect a portfolio during a recessionary period, our recommendation is that investors’ portfolios maintain PQI’s of 80% or higher. If your Portfolio Quality Index is below that level, then it may be worth a look.

2. Healthy Income Statements: If a company is in a downward spiral, its troubles are apt to be revealed much more quickly in its corporate income statement than in balance sheet calculations. For this reason in part, we pay close attention to the health of corporate earnings.

Again, rating services can be a useful tool to help monitor a portfolio of stocks. The Value Line Investment Survey is most well known for its focus on companies' earnings and their relative rankings. A Value Line "timeliness" rating of #1 or #2 indicates that a company is prospering at an above-average rate. To assess an entire portfolio's health with respect to the underlying companies' income statements, we rely on our proprietary Portfolio Growth Index ("PGI"), and feel that a PGI of about 80% is optimal.

## CONCLUSION

Over the years, I have had the opportunity to witness and review scores of investment strategies. My conclusion is that good investing is hard. The difficulty, however, is not so much in the complexity of a good strategy. Rather, faithfully adhering to a few simple rules can get an investor through the most challenging of times and position him for prosperity when better days arrive. Rather, the difficulty lies in the ability to take proper perspective. Cycles in the markets can be far longer than what many people realize. For this reason, the soundness of an investment strategy is often erroneously demonstrated by how well the strategy may have worked during the previous few years, or even for the seemingly long period of a decade or more.

Consequently, during prosperous times, investors may be seduced by the high returns

that have been recently earned with high-risk investments and strategies—yet that risk is unappreciated or willingly ignored in favor of the expected returns. Examples include:

- The Asian markets during the 1990s, prior to their collapse in 1998;
- The 1990s hi-tech dot-com era (when promoters claimed that we were in a "New Economy");
- Highly leveraged real estate investing (when we heard aphorisms such as "real estate never goes down" and "they're not making any more land");
- The emerging market investing of the past few years—Brazil, China, India, Russia—under the guise of yet another "new economy" and the alleged decoupling of global markets;
- And, of course, highly leveraged hedge funds, ironically marketed to people whom the industry labeled with (and amusingly lured them by) the title of "sophisticated" investors.

However, when such strategies turn tail, investor losses have often been so quick and steep that any chance of recovery has slipped far from grasp.

Similarly, during periods of distress, investors may flee what they perceive to be risky assets for those that they hope will provide safety.

Unwittingly, however, they may be jumping from the frying pan into the fire. Temporary market volatility, particularly when it is extreme, can look an awful lot like heightened risk of permanent loss. And a high-risk investment strategy can look like stability and safety when years have passed without incident. Distinguishing between the two is not always obvious but is critical to long-term investment success.

In recent weeks, the possibility that many investors have sold their stocks at historically low prices for the comfort of cash suggests, at least, that they may have sold the farm for just a handful of dollars—dollars that inflation is now eroding at the fastest rate in nearly two decades. Panicked mutual fund investors withdrew nearly \$60 billion over just ten days in October.

There is much to be said for having a portfolio populated largely with S&P A-ranked issues during tumultuous times. While high-quality stocks do not insulate us from volatility, if we realize that the underlying companies tend to be dominant within their respective industries and seem apt to survive even if their peers flounder, that can help assure us that the ship is, indeed, sound.

We remain as confident as ever that high quality portfolios of prospering companies are well suited to withstand any Round Three storms that may still lie ahead. To be sure, however, we well understand that the level of

fortitude required to endure this ongoing hurricane is immense.

To conclude with someone more sanguine than our friend Roubini, the following is an excerpt from Jeremy Siegel, a Wharton School professor of finance and author:

The case for equities at these levels is compelling. The last time we have seen prices this low was more than 30 years ago, when the US economy was in far worse shape than today. ...

The total losses in the world stock markets have been over \$30 trillion dollars over the past year. That is about ten times the entire size of subprime mortgages issued over the past five years, the purported cause of the current crisis. I believe a year from now we will be looking back on this October, kicking ourselves for not having the courage to buy stocks.

As always, whenever you have questions or concerns, we are pleased for your phone calls and e-mails.

Thank you.

—Russell B. Dow, J.D.  
President, Dow Investment Group

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