

Weekly Commentary

May 5, 2008

The Markets

There's an old saying that 90% of what people worry about never actually happens. Investors seem to fall into that trap, too, as they fretted about all sorts of economic problems over the past few months and as a result, drove down stock prices. However, several key economic reports released last week suggest that the economy may not be in as bad of shape as many people thought.

The Federal Reserve kicked things off with another ¼ percent cut in the Fed funds rate last Wednesday. The Fed seemed to signal that it was going to stand pat for a while and investors viewed that as bullish news, according to Associated Press. Reading the tea leaves, some investors viewed the “standing pat” idea to mean that the Fed feels the economy has enough stimulus in place to rev up its engine without further government fuel. This fuel includes the \$100 billion in rebate checks that are starting to fill our pockets.

Also on Wednesday, the Commerce Department said the GDP grew at an annualized rate of 0.6% in the first quarter, much higher than the 0.2% rate expected by economists surveyed by MarketWatch. While the headline number looked relatively positive, the devil is in the details. Upon closer inspection, some economists pointed out that much of the increase came from inventory growth and exports as opposed to things American households and businesses bought.

On Friday, the Labor Department said nonfarm payrolls dropped by a less than expected 20,000 in April. According to MarketWatch that suggests, “The nation's economic downturn may be short and shallow rather than long and severe.” The unemployment rate also dropped to 5.0% in April, down from 5.1% a month earlier.

On balance, last week's news gave bulls reason to cheer and they responded by pushing stocks higher. We'll need more time to determine if the market's rise over the past few weeks is the beginning of a new trend or just a head fake.

Returns through 5/2/08	1-Week	Y-T-D	1-Year	3-Year	5-Year	10-Year
Dow Jones Industrials	1.3	-1.6	-1.6	8.4	8.8	3.6
Nasdaq Composite	2.2	-6.6	-3.7	8.7	10.5	2.8
Standard & Poor's 500	1.2	-3.7	-6.1	6.8	8.7	2.3

Sources: Yahoo! Finance, Barron's. Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly. Three-, 5-, and 10-year returns are annualized. Assumes dividends are not reinvested.

HAVE YOU EVER SEEN A BLACK SWAN? Most likely the answer is no, but there's a good chance that you've been affected by one.

For some 1500 years, western civilization believed that all swans were white. In fact, the idea of a black swan was a popular metaphor in Europe, which symbolized something that could not exist. That all changed in 1697 when a Dutch explorer sailed into New Holland and made the first recorded European sighting of this elusive bird.

What was once thought to be non-existent – a black swan – turned out to be not only existent, but rather common in a certain part of the world. This is a lesson that we should all take to heart as it relates to investing.

Many models used by sophisticated investors are predicated on the idea that by using statistics, we can come up with the odds of certain events occurring. Using a made up example, looking at historical stock market performance, a model might suggest that the odds of the Dow Jones Industrial Average dropping by 10% in one day, is 1 in 6,000. With that data, a sophisticated investor might create a complicated transaction that tries to eke out a predictable return using lots of leverage. What we're finding is that in reality, the models some investors use may actually misprice the risk of certain events happening.

Nassim Taleb, in his 2007 bestselling book titled, *The Black Swan: The Impact of the Highly Improbable*, lucidly pointed out that on Wall Street, black swan events seem to occur more frequently than most investors expect. As a result, investors may be unprepared for negative events that were once thought to be highly improbable, but actually turn out to happen every few years.

In the past 25 years, Taleb pointed out a few “black swans” including the 1982 Latin American debt crisis, the October 1987 stock market crash, and the collapse of hedge fund firm Long-Term Capital Management in 1988. Perhaps the turmoil in the auction-rate securities market qualifies as another example.

The emotional nature of human beings makes us unpredictable. Taleb's insights help us understand that while “black swan” events may be infrequent, they do happen and we would be wise to incorporate their possibility into our investment planning.

Weekly Focus – Spend Some Time Thinking

You may find it helpful to pause for a moment and think about your life. When you are in the mood, take out a piece of paper and a pen, go to a quiet place, and do the following exercise.

Write a letter to yourself and reflect on your life's highs and lows, and joys and regrets.

After you finish, take some time to review it. What have you done well so far in your life? What have you done not so well? What do you need to improve? How can you eliminate the regrets before it's too late?

By doing this exercise, you'll learn a great deal about yourself and still have some time to improve upon the areas where you are currently falling short.

Best regards,