



THE ADVOCATE GROUP

A Bridge to Financial Clarity

Weekly Commentary September 22, 2008

The Markets

“Historic” is not a word we use lightly, but it seems appropriate to describe what took place in the financial markets last week.

As you look at the box score below, it masks the volatility that took place in one of the wildest weeks in Wall Street history. When the dust settled, the broad S&P 500 index finished the week with a slight gain, but it took some pain to get there. Last Monday, the Dow Jones Industrial Average dropped 504 points, followed by a gain of 141, a loss of 449, a gain of 410 and it closed the week with another gain of 368 points. Whew!

By Wednesday of last week, the world financial system was teetering on the brink of collapse. Credit markets had frozen, banks were unwilling to lend to each other and stock markets were plunging. A vicious death spiral was spinning out of control. After trying a “plug the hole” policy that had failed to stem the crisis, the U.S. government threw out the playbook and decided it was time to act decisively. By late last week, the government marshaled all its resources and created a plan to try to put the crisis behind us for good. The stock market liked what it was hearing and it staged a huge rally the last two days of the week. Let’s hope it continues.

Returns through 9/19/08	1-Week	Y-T-D	1-Year	3-Year	5-Year	10-Year
Dow Jones Industrials	-0.3	-14.2	-17.6	2.6	3.4	3.7
NASDAQ Composite	0.6	-14.3	-14.9	2.0	3.6	3.1
Standard & Poor's 500	0.3	-14.5	-17.7	0.6	3.9	2.1

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

THE PAST, THE PRESENT, AND THE FUTURE OF THE CURRENT FINANCIAL SITUATION

In light of the recent turmoil, this week’s report will be longer than usual. We thought it would make sense to discuss the past, present, and future of the current financial situation. This may help put things in context for you.

The Past

In order to understand how we can get out of this mess, it's necessary to figure out how we got into it. The late 1990s is a good place to start.

No doubt you remember those "good ol' days." The internet was changing the world, technology stocks were soaring, and the economy was humming along. It was a great time to be in the stock market as the S&P 500 index rose 220% for the five years ending December 31, 1999, according to data from Yahoo! Finance. That's an average annualized return of 26% excluding reinvested dividends, which is simply phenomenal.

Of course, the good times didn't last. The bubble popped and the S&P 500 declined by 49% between March 2000 and October 2002, according to data from Bespoke Investment Group. In order to limit the collateral damage to the economy from this steep decline, the Federal Reserve, under former chairman Alan Greenspan, embarked on a major interest rate cutting campaign to try and stimulate the economy. The Fed took the federal funds rate from 6.5% in May 2000 all the way down to 1% by June 2003, according to data from the Federal Reserve Bank of New York.

This precipitous decline in interest rates set the stage for the next bubble – real estate.

With interest rates super low and the stock market in a funk, investors turned their attention to the previously moribund real estate market. As the economy gradually improved, people started to buy homes again in a big way. And banks, mortgage companies, and Wall Street wizards were more than happy to come up with new fangled ways of getting Americans into the home of their dreams with little to no money down.

Wall Street investment banks were thrilled with this new opportunity in real estate because they weren't making much money on their traditional business of investment banking and buying and selling securities. By coming up with new ways to package, slice, and dice mortgage securities, Wall Street firms made a boatload of money. Unfortunately, many of these new securities, which provided capital to finance the real estate boom, were highly financed themselves. Effectively, the actual equity that underpinned some of these mortgages was negligible.

When the real estate bubble became unsustainable, just like the earlier technology bubble, it all came crashing down.

With very little equity supporting billions in outstanding mortgages, a slight decline in the value of the real estate caused a ripple effect of delinquencies and defaults. As the defaults spread, it began to feed on itself like a California wildfire inhaling dry timber. Eventually, fear took over as nobody knew when the vicious cycle would be broken. Enter last week.

Investors had weathered blowups from Countrywide, Bear Stearns, Fannie Mae, Freddie Mac, and now, they were facing major problems with Lehman Brothers, AIG, and Merrill Lynch. By week's end, Lehman had been forced into bankruptcy, AIG had been effectively nationalized by the government, and Merrill Lynch had taken refuge in the arms of Bank of America. This tumultuous turn of events propelled the government to act swiftly and decisively.

The Present

The situation is fluid and changes are happening with lightning speed. Over the weekend, the Bush Administration sent to Congress a \$700 billion proposal that would give the Treasury broad authority

to purchase distressed assets from U.S. financial institutions in an effort to stem the crisis. The proposal would also raise the nation's debt ceiling to \$11.315 trillion from its current \$10.615 trillion limit, according to Bloomberg. To put \$700 billion in perspective, that translates into an average bill of \$6,500 per U.S. family, according to a report from MarketWatch. Now, it's possible that the Treasury will turn around and sell the assets and recoup some or all of that \$700 billion, but that will not be known for perhaps years.

We also don't know how hard of a bargain the government will drive when it tries to buy these distressed assets. If it tries to buy the assets at a very low price, then the financial institutions may have to take more write-downs and raise more capital, which could keep this vicious cycle spiraling down. Conversely, if it buys the assets at a high price, then the financial institutions benefit at the expense of the taxpayers who are on the hook for any future losses.

In a surprising twist, investment banks Goldman Sachs and Morgan Stanley announced late Sunday night that they will convert their businesses into traditional bank holding companies, according to *The Wall Street Journal*. This will subject the companies to new regulatory oversight and possibly significantly reduce their future profit opportunities. It may also put the companies in a better position to be acquired, to merge, or to acquire a smaller bank with insured deposits.

In other news last week, the Treasury announced that it is extending bank deposit-type insurance to money market funds. The news of a money market fund that "broke the buck" prompted the government to implement this safety net as a way to limit further damage in the \$3.3 trillion money market industry, according to Bloomberg. Also, on Friday, the Securities and Exchange Commission implemented a ban on short-selling 799 companies through October 2. This may ease some of the pressure on these companies and shield them from "bear raids" that could depress their stock price.

The changes announced by the government late last week helped spark a huge rally in stocks on Thursday and Friday. Nobody knows whether this is just a temporary reprieve or the beginning of a new period of stability. What we can say with some confidence is the government is all over this situation and they are trying to do all they can to prevent a replay of the 1930s.

The Future

As the old saying goes, "Forecasting is the art of saying what will happen, and then explaining why it didn't." At the risk of having to explain ourselves later, we'll offer some comments about what the future may hold.

First, capitalism as we know it may have changed dramatically. The concept of letting free markets adjust and self-correct with minimal government intervention is likely gone. The government's actions over the past few months indicate that there are limits to laissez faire. We may see more government regulation and that may mean lower long-term returns from securities because the regulations could remove some of the risks from investing.

Second, when a financial calamity is knocking on the door, a small number of people may assume tremendous power to make decisions that put hundreds of billions of taxpayer dollars at risk. Right now, Treasury Secretary Hank Paulson is arguably the most powerful person in America. He and his coterie of trusted advisors are massively reshaping our financial system with bullet train speed and little oversight. When the history books are written, Paulson may go down as the greatest Treasury secretary of all time or we may be throwing darts at his picture. Time will tell.

Third, we live in a global society that is highly connected through commerce and instantaneous communication. What happens in the U.S. is no longer a U.S. issue and vice versa. As a global society, we may all sink or swim together – so we all better get along. The financial crisis we're experiencing is a great example. It's not just isolated to the U.S. It has global ramifications.

In Closing

As we wrap up this extended commentary, we need to keep in mind that it took us years to get into this mess and it may take us years to get out of it. The government's unprecedented action last week may have stopped the bleeding, but that doesn't necessarily mean the patient is well. We still have a glut of homes on the market, a relatively soft economy, and a host of other headwinds. With that said, new opportunities may arise and we are always on the lookout for them.

No matter what the market may throw at us, we want you to know that we are closely following the situation and we are doing all we can as professional advisors to be good stewards of your money. If you have any questions, please let us know. Thank you for the trust and confidence you've placed in us. We've worked hard to develop it and we are working hard to keep it.

Weekly Focus – Think About It

“God, grant me the serenity to accept the things I cannot change, the courage to change the things I can, and the wisdom to know the difference.”

-- Reinhold Niebuhr

Best regards,

The Advocate Group

P.S. Please feel free to forward this commentary to family, friends, or colleagues. If you would like us to add them to the list, please reply to this e-mail with their e-mail address and we will ask for their permission to be added.

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* The NASDAQ Composite Index is an unmanaged, market-weighted index of all over-the-counter common stocks traded on the National Association of Securities Dealers Automated Quotation System.

* Yahoo! Finance is the source for any reference to the performance of an index between two specific periods.

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