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BENEDICT FROM THE 5TH FLOOR

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THE STATE OF "THE MESS!"

WHAT HAPPENED?

Almost everyone saw it coming...a large segment of Americans had become financially obese. Where savings should have been was credit card debt; where home equity should have been was re-financed home mortgages; where good collateral should have been was no collateral.

People were literally spending tomorrow's bread and milk money for today's excesses. Six dollar cups of coffee were the norm, dinners for two costing more than normal families spend for food for an entire week, homes were debt-burdened mansions and cars were extreme status symbols - many encumbered with debt that far exceeded their value.

The credit bubble has popped and many of the financially obese are on a forced financial diet of necessities and paying off yesterday's excesses. Some with houses will simply walk away from their obligations and some with moderate incomes will allow the bankruptcy courts to wipe their slates clean. But, there are also many financially obese house-holds that can't really do either of these actions, or are not ready to accept the reality that they may have to, and are forced to dramatically change their standards of living and expectations. This is financially painful. This is psychologically painful. This is socially painful. This is no fun!

In addition to the financially obese households, there were the financial geniuses of Wall Street and the giant banks that figured out how to defy gravity...they were able to lend with little hope of being repaid and make money doing it...a lot of money, until...

We have witnessed "excesses" in all areas of life by those who have the power or the opportunity, but the games these firms were playing were not only dangerous, but just plain stupid. Some blame capitalism for their actions, but capitalism is about good competition -- not rampant abuse of position. And, I don't want to hear the excuse that "all the other firms were doing it." The officers of a public corporation have a duty to the shareholders, the employees and the public in general. We should probably have seen this coming in the mid-90's when the distinctions between banks and brokerage firms were pretty much eliminated.

I'm not sure I want the government to come in with a new set of complex rules; the same excesses are very unlikely to happen the second time. I'm not sure I want the regulators to throw a bunch of these guys in jail. What good would that do other than feed the revenge factor? I really want the shareholders to vote out each and every board member who allowed the corporate officers to act so totally irresponsible and then rewarded them so handsomely. Hit them where it really hurts...their pocketbooks and their egos!

WHAT IS HAPPENING WITH THE ECONOMY?

In trying to figure out what is happening with the economy, my search has uncovered many incongruities such as:

Gas is so expensive no one can afford to drive.

- Yes, but a recent trip on I-75 put me with cars bumper to bumper and shoulder to shoulder. I read where total miles driven have dropped for the first time in years by slightly over one percent. Let me get this right, gasoline has skyrocketed and miles driven has declined only one percent? I don't understand.

Fuel is so expensive that no one is flying.
- Yes, except my two plane trips in the last two weeks involved packed airports and full occupancy planes.

Consumers have quit buying.
- Yes, but I was slowed down on a freeway (apparently due to a lot of traffic) and able to overlook the parking lot of a major shopping mall on a recent Sunday afternoon…I saw almost no empty parking places. And, I was in southeastern Michigan - not the north side of Atlanta.

People everywhere are without jobs.
- Yes, but I read where the new claims for unemployment benefits has decreased some weeks and only modestly increased others.
- I read where Caterpillar is providing incentives for older workers to come back and operate the big equipment because they don't have enough younger skilled operators.

Is it the "excesses" that are most impacted?

- It is reported that cab drivers in Las Vegas report business is slower than after 9/11. Is it because almost everything Las Vegas stands for is a meaningless excess?
- Starbucks announced it is closing hundreds of stores nationwide. That is a shame! Now you won't be able to sit in your local Starbucks and watch the people in the Starbucks across the street.

Is it all in my head or are some parts of the economy humming while others are coughing? Some are panting and some are literally dead.

I think it is all of the above. It appears that many areas are still doing well; however, even in those areas much of the froth that was imbedded into the economy a couple of years ago seems to have disappeared. As David Denby said in his book *American Sucker* when he found out that speculating on rumors about Internet stocks was not going to make him his millions," I hated losing the freedom to be financially irrational."

I do believe this slow-down is being postponed because many of the irrational participants are now living on what medical people call their *functional reserves*. They are adding to credit card debt, they are postponing necessary maintenance and repair and they are drawing on their parents and siblings.

But, don't forget that economic slow-downs are a very natural part of our economic cycle and can be very healthy…in the longer-term. Many of the lay-offs are the tightening up of a bloated staff, which is one way employers have of remaining competitive. As unfortunate as it may be for the staff that was forced to depart, it is a natural part of the evolution of a business. What is more painful than the lay-offs is the longer-term impact when actions were not taken that should have been.

You see a company's first instinct, when they encounter increased costs and/or declining revenues, is to raise prices to pay for the extra costs or compensate for the reduced revenues. This action is usually the beginning of the end as competition feeds on the bloated company like a lion in the jungle eats the slowest of his prey.

The media focuses on the stress and humiliation of the displaced worker; however, in many cases this employee has been freed to find new and better employment…most likely in a new and growing company compared to the old and possibly stagnant environment that they just left. For the terminated employee, the transition is not without stress and pain, but for those who *take the bull by the horns* and really look for the exciting new opportunities, many will be well rewarded with a new lease on life. While those who sit around waiting for things to return to *normal* - may be sitting a long time.

WHAT DOES YOUR CRYSTAL BALL SEE FROM YOUR FIFTH FLOOR PERCH?

> "I just can't take it anymore. I don't know why any human should have to try and endure such madness. The market is up two hundred points one day, down three hundred the next. The Chinese are hoarding all our dollars; we won't have any jobs left in this country in two more years. The budget deficit is totally out of control, everything is far worse than ever before."
>
> If I were a doctor, I would diagnose a case of believing entertainment provides wisdom.
>
> Just turn off the television news. No long-term retirement security has ever been created by the *information* you receive from the financial news media. It is designed for entertainment and ratings. You will get about as much meaningful financial education from the financial media as your daughters will get good family values from watching the lives of the Hollywood starlets.

(This year, people have withdrawn over $45 billion out of mutual funds and exchange traded funds. *Wall Street Journal*, July 19, 2008) Shouldn't they have withdrawn this when the market was doing well, not now?

Real "Hurt" for the Big Financials

Do not underestimate the trouble that most of our big banks and brokerage firms are in. Many have dramatically reduced dividends and should probably eliminate them...what good is a dividend if the company doesn't stay in business? Most have raised additional capital by selling preferred shares that are convertible to common shares, thus diluting the ownership of existing shareholders. And, maybe most importantly, many are selling the family heirlooms to stay in business.

> SunTrust sold ten million shares of their Coca-Cola stock that they have owned since Coke went public in 1919...is that not a family heirloom? This was not a decision that was made lightly by a bank that did not need cash. It is likely the Lehman Brothers will have to sell their very profitable and very good Neuberger and Berman asset management division. Merrill Lynch has sold its 20% interest in Bloomberg LP back to the mayor. (The mayor of New York City, Michael Bloomberg, that is.) And, many feel they have no choice but to sell their 49% interest in BlackRock, Inc. And, the list goes on.

Thus, please be aware that, if you decide to invest in their companies, you may be getting a lot less company than in the past.

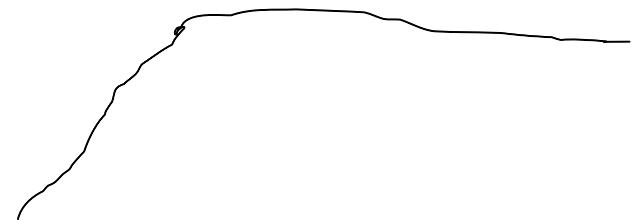
Other than the Big Banks...

It appears that we are in the middle of a financial crisis and it is a big one! I'm not trying to downplay the mess; however, my take on it is that we are well past the middle of the crisis.

I believe we will weather this financial tornado and life will return to some form of normalcy. This does not mean that I think residential real estate prices will shoot back to the unrealistic levels of two years ago nor does it mean that the financial damage that has been done will not haunt us for many years to come. (Much residential real estate and the domestic automobile industries are in deep depressions.)

It also appears that in some form or another our political leaders will yield to the overly debt-burdened and provide *relief* from their predicament. Of course, the financing for that *relief* will fall on the shoulders of the non-debt burdened taxpayers...I'll thank most of you right now for your contribution to their *relief.*

However, I believe the mortgage mess and the political banter have covered up some very bright spots in our economy. First, look at this very primitive chart:



I'm quite certain that you are looking at the chart thinking something like..."that guy must have dropped out of school at an early age." Actually, it is a chart I drew on an email to the rest of the office in August 2007 with the notation: *My guess is the China dominance ended this summer. China imports are likely to look like this in the future.*

I was somewhat right; the reality is that imports from China have actually decreased more than the chart predicted. Manufacturing is returning to America. That's good news! The bad news is that the new manufacturing is, generally, not using the old rambling factories of yore and it is not locating in the former geographical hotbeds of US manufacturing.

> **Where are the new manufacturing jobs going?**
>
> In an era in which almost everything can be made anywhere at anytime by people who speak any language, jobs will go to where they are treated best.
>
> It isn't always just low wages; it's the overall productivity costs that count. It isn't necessarily good weather, its good employee work traits and skills. Good transportation is critical, and with today's energy costs, a manufacturing site near the consumer is valuable. Lastly, employers are looking for a legal and cultural environment where their rights are protected and taxes…a definite cost of production… cannot be ignored.
>
> Thus, I would encourage any area that is not attracting new jobs to look at what they have to offer.

The other good news is oil may have already reached it peak and we could easily see a significant decline by the end of the year. I have notes to write an entire newsletter on this decline of oil prices, but I may have waited too long.

I'm guessing that the new President is likely to see an energized stock market about the time of the inauguration. I don't believe it will matter which candidate wins the election, or even the fact that it will be a new President. I just think that will be when the bad times run their course and a new cycle begins. Good markets almost always follow bad markets. Thus, I would expect your investment account one year from now to look healthy and vibrant…that is, unless you have been withdrawing too heavily on the account.

Now that is said, please also remember that, generally, the stock market starts to show improvement about mid-way through an economic recession. Thus, the economic clouds may still linger well into the new Presidential term.

The Financial Markets…What Do You Do?

When you get into a boat to cross the seas, you must remember that the boat you choose must be able to move you expeditiously across the waters - but also withstand any rough seas you may encounter.

Investing is very similar to crossing the seas. Sometimes, in the middle of the journey, you encounter rough seas, scary seas and your instinct is to abandon the boat. Unfortunately, that usually does not solve your problem. We have no choice other than to stay the course, which generally means hold tight to our investment strategy.

This may sound simplistic, and there are times when major strategy changes were warranted (2002-03 for example), but, generally, history will show staying the course to be the best longer-term answer.

The other thing that is difficult to understand is that in the investment markets when risk seems greatest, it isn't. And, when times seem least risky, they are most risky!

Let me explain. If you have just endured a bad hurricane, you are battered, but most likely the hurricane is over and you won't have to endure another one for many years. However, this is the time that the most sought after media experts will be the ones who are predicting more storms. The same holds true in the investment markets…we are closing in on a period of relatively *low risk* because most of the storm is behind us. However, we just can't look to the skies and get a good reading to know for sure when the storm is past.

What do you do in your office to remain so calm during these terrible market times?

- First of all, we have lived through them before. Market declines greater than fifteen percent have been occurring every few years since Dow Jones[1] was a baby. (Since 1980, we have had six market declines greater than fifteen percent. However, during that time the Dow Jones has increased from less than 1,000 to today's level of over 10,000.)

- We also work in "percentages" and not "dollar amounts." Let me explain. If we are reviewing an account in a market like this, one of our first tests will be what percentage the account is down in value. You see, we pretty much know ahead of time how sensitive an account is to the overall market and this exercise verifies the accuracy. We know we can't create investment accounts, at least not good investment accounts, which go up when the market goes down. There is no sense fighting that, but we can create good investment accounts that are only fifty percent sensitive to market declines, for example. Also, by focusing on percentages, we take a lot of the emotion out of the decline. Let's say you have one million dollars in an account. We may look and say it is down ten percent and the market is down twenty percent, that's about what we expected. However, you may look at the monthly statement and say "I've lost one hundred thousand dollars, that's more than I paid for my house. I don't want to lose another one hundred thousand dollars." That is a very understandable emotion. Watching your dollars depreciate is very emotional.

- We also take the approach that we do not have the ability to sell our investments at the top of a market cycle and buy back in at the trough. This sounds so easy, but it does not work, so we don't think about it.

- We also focus on the income an account is earning. For example, if our client needs the account to distribute $3,000 per month, for example, and the account is earning that amount or more, then for all practical purposes it doesn't matter if the account value goes up or down.

What Should I Do Now?

This is a great time to forget the stock market and focus on your overall financial plan. Where are you? Where do you want to be? What things do you control? What things do you not control?

Forget CNBC, Cramer and the like and focus on something important…YOU AND YOUR FAMILY!

Focus on what you can control - and ignore what you can't!

[1] The Dow Jones Industrial Average is an unmanaged index that cannot be invested into directly.

FANNIES AND FREDDIES…and the boys!

In the late 1930's, the residential housing market was in shambles as private lenders were leery of making any loans. The government came to the rescue with the creation of the **Federal National Mortgage Association** [Fannie Mae to the "boys" in the industry]. Fannie Mae would purchase mortgages from the local banks or guarantee the mortgages issued by local lenders.

In 1968, the government wanted to get the cost of supporting Fannie Mae out of the national budget and "sold" the ownership to the public. Thus, it became a public corporation…almost. Actually, it began operating as a **government-sponsored enterprise** [or a GSE to the "boys"], a private company owned by shareholders and listed on a stock exchange, but at the same time "maybe" financially protected by the federal government, AND, not regulated like all other public companies.

In 1970, the government came up with the idea that if they created another government-sponsored enterprise to compete with Fannie Mae, competition would be good and force the two firms to act like profit-making companies. Thus, the creation of the **Federal Home Mortgage Corporation** - or Freddie Mac to the "boys."

Fannie and Freddie would make money by re-packaging the mortgages into bonds and selling them to investors, with the assurances that they would make good any bad mortgages, thus the two agencies have guaranteed trillions of dollars of mortgages.

The two organizations have had their share of scandals over the years with charges of poor accounting being the most common. The fact that the government made them exempt from the Securities and Exchange requirements that other public companies follow probably helped encourage rather loose management. And, add to this the fact that they are basically part of the crony political system…the two companies spend more on lobbying each year than any two other companies in the country.

In the current environment with foreclosures the *event of the day*, you can see where the two organizations have or will soon incur losses far greater that their equity and are, or will be, insolvent. Assuming their accounting is anywhere near correct, a very big assumption, they have "equity" equal to about four percent of what they have guaranteed. Thus, if the value of their mortgages fall more than four percent, they are essentially bankrupt…this is where they are today or were before the bail-out.

I doubt this will go down in history as a good bail-out. Many will argue that the Federal Reserve *bailed-out* Bear Stearns and the rest of the big banks, what's the difference? Shouldn't we help the poor homeowner who is about to lose his home?

First of all, almost all of the money that the Federal Reserve fronted the big Wall Street banks will be repaid. None of the money that Congress is giving Fannie and Freddie will ever be repaid…it is a liability of the US Government and an obligation for future taxpayers. And, I doubt that many stressed homeowners will see any benefit. The best argument you can make is that keeping Fannie and Freddie alive keeps mortgages flowing for new homeowners. I guess, but I believe money will always be available for *good quality* mortgages…ones in which the lender feels there is a good chance he will be repaid.

Fannie and Freddie should have been allowed to go bankrupt much like Delta and Northwest Air. The shareholders would have lost all their investment and the bondholders would have taken over ownership of the "companies." They could have remained in business, much like the two airlines, conducting business as usual, hopefully, business a little better than usual. Granted, the bondholders would not have been able to get 100 cents on their dollars, at least for many years, but that is the risk investors take.

Why didn't it happen this way? My guess is politics and foreign relations. Politics…the public wants a solution to the mortgage crisis (this isn't) and Foreign Relations…a lot of the Fannie and Freddie bonds are owned by foreign governments.

Remember that Fannie Mae was created in 1938. In 1944, Henry Haslett wrote his book *Economics in One Lesson.* Below is a quote out of his book.

> *The collapse of a credit "bubble" has far greater consequences than the collapse of a stock market "bubble." Government-guaranteed home mortgages, especially when a negligible down payment or no down payment whatever is required, inevitably mean more bad loans than otherwise. They force the general taxpayer to subsidize the bad risks and to defray the losses. They encourage people to "buy" houses that they cannot really afford. They tend, eventually, to bring about an oversupply of houses as compared with other things. They temporarily over stimulate building, raise the cost of building for everybody (including the buyers of the homes with the guaranteed mortgages, and may mislead the building industry into an eventually costly overexpansion. In brief, in the long run they do not increase overall national production but encourage malinvestment.*

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