

The Advantage Advisor

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Market Commentary:

As I've illustrated in the box below, this is most definitely a market of extremes. A glance at the performance figures to the right certainly testifies to the negative forces at work in the financial markets. Remember though, that the markets always move too far in either direction and then eventually reverse course to correct that mistake. And when those moves are fast or extreme, as is the present case, the turnarounds also tend to be fast and extreme.

Possibly the greatest example of the extremes the market is experiencing is in the municipal bond marketplace. Municipal bonds are issued by local governments or their agencies, and are guaranteed by the local government and usually by a bond insurer such as MBIA. However, the fallout over the sub-prime mortgage meltdown has raised questions about the viability of those bond insurers and so suddenly, there are no buyers interested in those bonds. As a result, bonds for the New York Port Authority recently saw their yields soar to 20 percent - higher than that of most high risk emerging market debt. This represents a complete disconnect from reality.

Here is another example about just how overdone the flight away from risk has been. On January 23rd, the 30 year US Treasury bond yield fell to its lowest level *ever*. That includes where it stood after the Fed cut interest rates to a mere 1% back in 2003. As a result, the difference between corporate bonds and treasury bonds, known as the spread, has also widened to historic levels.

Market Statistics for January

Market Index	Closing Price	% Change
Dow Jones Industrial Average	12,650	-4.6%
S&P-500 Stock Index	1,379	-6.1%
Russell 2000 Stock Index	713	-6.9%
Shearson Treasury Bond Index	15,646	2.75%
Dow Jones World Stock Index	277	-8.0%
Nasdaq Composite Index	2,390	-9.9%

Yet one more extreme in the markets can be seen in commodities prices which have risen virtually unchecked over the past several years. This rise is certainly reminiscent of the other asset bubbles we have seen in the last decade. It is very likely this will be the next bubble to burst, especially if there is a global economic slowdown.

The financial markets seem to be fixated on the negative for the time being, with the potential for recession still rising. While we have seen some short lived upward moves in the markets, the major trend appears still to be toward the downside. Because of that, we remain cautious in our positions and look for stocks to fall moderately lower before we see any real recovery getting underway.

Once we do see that shift back to a bull market, it is likely we will see quite a strong move. Stock valuation levels remain very cheap. The current price/earnings ratio for the S&P-500 stands at 13.7 times forward earnings. This represents an 18 year low in that measure of value. The average P/E ratio for the S&P during times of comparable inflation is 18.6 times. That means there is substantial value being built into stocks, and that should translate into significant gains once our economy gets back on its feet.

A Market of Extremes

- ◆ Stocks have dropped by 15 to 20% in only a few months.
- ◆ US Government Bond yields have hit all-time lows.
- ◆ Corporate and high yield bond spreads are at extreme levels above US Treasury bonds.
- ◆ **High levels of anxiety on "Main Street" with fear of recession growing.**
- ◆ Rising concerns over home values and the housing market.
- ◆ Unprecedented lack of confidence in the credit markets.

The Economic Picture

Economic growth slowed as if running into a wall during the fourth quarter of 2007. We saw a shift from a growth rate of 4.9% in the third quarter to an anemic 0.6% in the fourth quarter. The average estimate of growth was twice that, or 1.2%, so this report came as a real shock.

In response the Fed lowered rates by an astounding 1.25% during the last week of January - .75% at an emergency meeting and .50% at their regular meeting on the 30th. In addition, the Fed issued a statement that they stood ready to provide even more stimulus to the economy because they saw the potential for growth to slow further during the first half of 2008.

The market is currently forecasting that the Fed will cut rates to around 2% by this summer. That, in addition to the fiscal spending package recently passed by congress, would provide significant stimulus to our economy and hopefully keep us out of an true recession. Though the actual dollars involved in the fiscal package are not really enough to change the course of the economy, it is the psychological impact that will really make the difference.

Looking at our economic indicators, we can see that overall things remain fairly stable. In our growth section, we can see that although GDP growth has slowed, other areas are holding steady. A good indicator

Current Economic Position:
Stage 4 - Late Growth / Stage 5 - Contraction

Economic Indicators

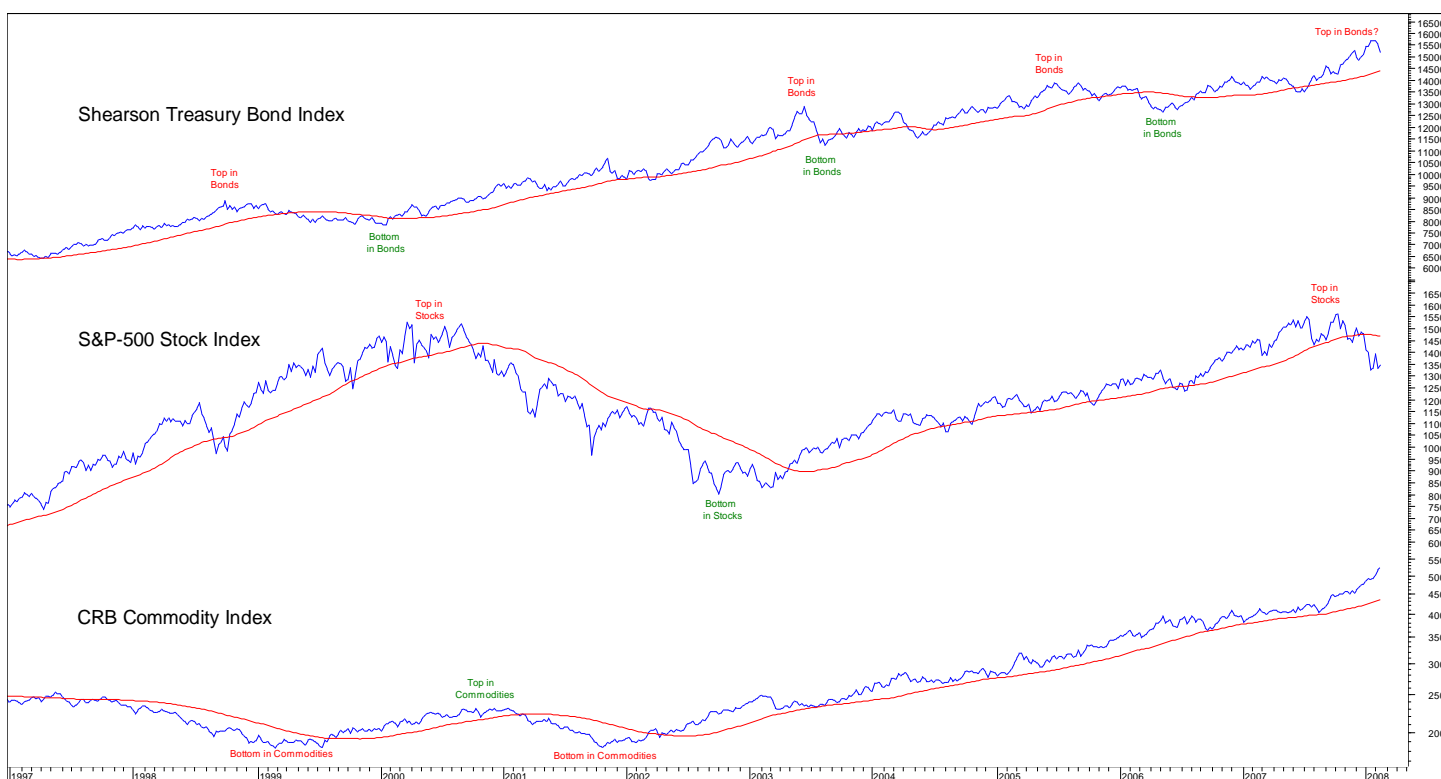
	<u>Latest</u>	<u>Prior</u>
Growth		
GDP	+0.6%	+4.9%
Productivity	+1.8%	+6.0% ↓
Employment Cost Index	+0.8%	+0.8%
Capacity Utilization	81.5%	81.5%
Inflation		
Consumer Price Index	+0.3%	+0.8%
Core PCE Deflator	+0.2%	+0.2%
Implicit Price Deflator (GDP)	+2.6%	+1.0%
Sentiment		
Consumer Confidence Index	87.9	88.6
Unemployment Rate	+4.9%	+5.0%
Personal Income	+0.5%	+0.4%

↑=revised up, ↓=revised down

Source: Moody's Economy.com

here is the Capacity Utilization rate of 81.5%. The economy runs best when factory use runs at between 80% and 85% of capacity. Reading above or below those levels tend to signal trouble.

On the sentiment side, consumer confidence is still declining, but both the unemployment rate and personal income remain stable. If we were truly heading into an all-out recession, we could expect to see the unemployment rate rising quickly toward 10%. So long as that rate stays stable and below the 6% level, any slow-down is likely to be a contraction in growth rather than an all-out recession.



How will our investments fare through a recession?

With all of the concern in the news media over the possibility of a recession, it is certainly a fair question to ask: “If we do fall into a recession, how will our investments behave, and are we ready if it does happen?”

The good news is that we have already been preparing for an economic contraction, so our investment portfolios are already prepared. Thanks to our economic tracking model our investment strategies are already in defensive postures. Our forecast is for stocks to fall to lower levels through this summer, but then to begin a strong recovery thereafter. That means we are watching for buying opportunities, but are not ready to get back in quite yet.

We always manage our client’s portfolio in light of the potential risks and rewards. With that in mind, here are a few of the ways we protect our client portfolios during down markets:

Protection for investments during down markets:

1. *Diversification*

The most important factor in protecting any investment portfolio from risk is diversification. The easy rule of thumb here is: “Don’t keep all of your eggs in one basket.” We diversify our client portfolios in two ways. The first is diversification within each investment strategy. We look to be sure that our strategies hold a variety of investments within whatever sector or asset class we hold. The second is diversification amongst strategies within a portfolio. Each of our clients has unique needs

and goals, and therefore each portfolio is tailored specifically for them. We use a mix of our investment strategies within every portfolio in order to provide maximum diversification for each client according to their needs.

2. *Optimal Portfolio Allocation*

Studies have determined that more than 90% of the performance of an investment portfolio is due not to the individual investments, but to the overall allocation of those investments. This is where our economic stage analysis comes into play and gives us a distinct advantage. By monitoring the position of our economic growth within that framework, we can target just which types of investments will perform best, and which to avoid. That allows us to balance the investment allocation for each of our strategies to the most beneficial (optimal) mix for each investing environment. A good example of this was our shift in the Stock strategy in 2007 from small cap to large cap stocks. That move allowed the strategy to outperform the S&P-500 by nearly a four to one margin.

3. *Planning Ahead*

When Wayne Gretzky was asked his secret to being such a successful hockey player, he said it was simple: You just need to make sure you are where the puck is going to be, not where it already was. The same is true in investing. The temptation is to view your investments in light of what is happening here and now, but that leaves you chasing performance. Once again, using our economic analysis we position our investments for where things are heading six to nine months down the road. Sometimes that means we are a bit early for the upswings, but it also means we are ready when they do happen and not trying to play catch up.

Investment Strategy Review

Stock Strategy

The Stock strategy grew even further defensive during January. During the month we reduced our exposure to hot spots such as technology and China. We also used our cash holdings to introduce a hedge position. That position offsets our large cap stock holdings as it moves in the opposite direction of the S&P-500 stock index. Effectively, that means we have reduced our exposure to large cap stocks from 60% to only 24% and raised our cash position to 36%. Because we expect

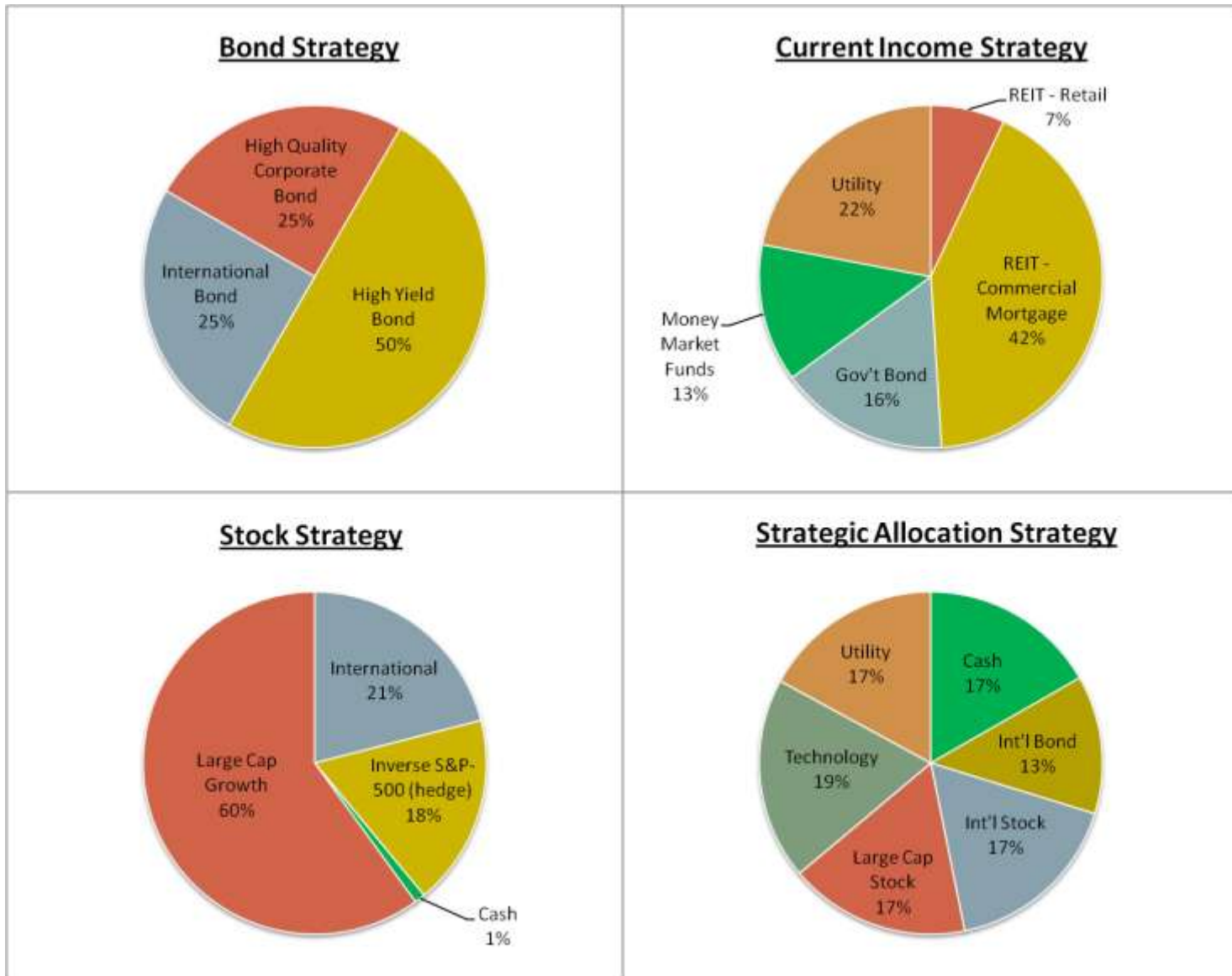
volatility and market weakness to continue for the next several months we plan to hold this position until late spring or early summer.

Strategic Allocation Strategy

This strategy remained unchanged during January. The positions in cash, international bonds, and utilities have provided some good shelter from the weakness and volatility experienced in other sectors. As this is a more aggressive strategy we are watching for opportunities to put that cash posi-

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Current Investment Management Strategy Allocations



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tion back to work. For that we are watching sectors that have seen an overcorrection in price such as technology and even banking and financial services.

Bond Strategy

The bond strategy continues to hold around 50% in high yield bonds, 25% in international bonds, and 25% in high quality corporate bonds. While we may yet be a little early in our posture for this strategy, we certainly want to be ready for the potential rally to come. We saw similar conditions within the bond markets and economy at the end of 2002, when the Fed cut rates down to a mere 1%. The response for such stimulus was one of our best years ever in bonds as the strategy gained 11% in 2002 and an incredible 25% in 2003. Of course

there is no guarantee of a repeat of those kinds of gains, but things are lining up for solid performance ahead.

Current Income Strategy

The extreme selling that took place last year in income producing assets appears to be starting to unwind. Our current income strategy has a current yield of just under 7%, which is almost double that of the ten-year treasury bond and several times current bank savings rates. In just the first month of the year, this strategy gained around 2% even while there were broad losses in the equity markets. We continue to hold a more conservative cash position in the strategy and will likely do so for the next several months until the market volatility slows.