

# The Advantage Advisor

Volume 12, Issue 1

January, 2008

## Market Commentary:

The year 2007 was almost exactly split in two for the financial markets. In the first half, the markets were moving along very nicely, and most asset classes were up better than 5%. The exception being US Government Bonds, which were down somewhat as expectations were for the Fed to raise interest rates later in the year, in order to restrain economic growth and cool any prospects for inflationary pressures. We were in a full growth mode and on target for yet another great year in the stock markets.

Then, seemingly out of nowhere, the bubble burst on the sub-prime lending markets and everything fell apart. As a result, the second half of the year looked almost like a negative image of the first. The most visible change was the complete reversal in the course of US Treasury bonds, which shot up at historic speed. This was driven by a global mass exodus out of virtually every other asset class and into the relative safety of US Government guaranteed investments.

Right now, the financial markets are under significant pressure. Looking forward, it is likely we will see all of the major indices at lower levels six months from now, but at higher levels nine to twelve months after that. For that reason, we have made significant moves within our investment strategies to take on a much more defensive

Market Statistics for December		
Market Index	Closing Price	% Change
Dow Jones Industrial Average	13,265	-0.8%
S&P-500 Stock Index	1,468	-0.9%
Russell 2000 Stock Index	766	-0.2%
Shearson Treasury Bond Index	15,226	-0.4%
Dow Jones World Stock Index	301	-1.4%
Nasdaq Composite Index	2,652	-0.3%

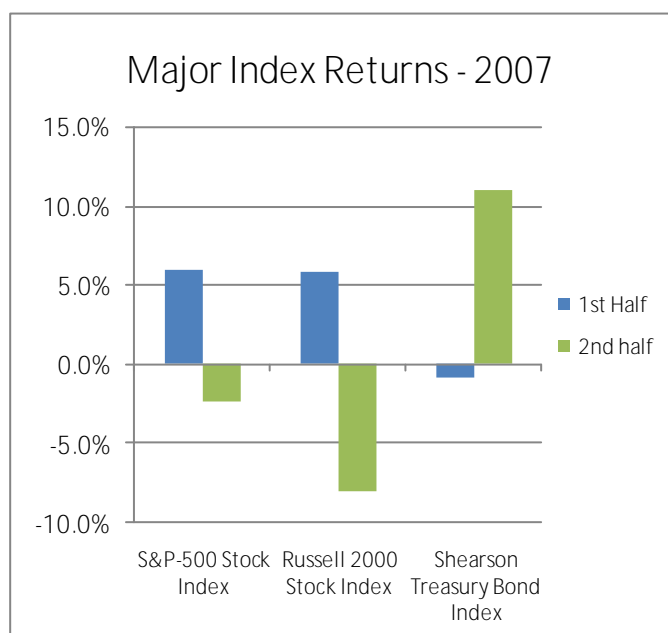
  

Market Statistics for 2007		
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posture. We have raised our cash holdings in each of the stock, strategic allocation, and current income strategies. In addition, we have shifted our allocation in the bond strategy to a more defensive posture from high yield bonds and into high quality corporate/government bonds. For a more detailed look at our current allocations, please see the charts on page four.

We are continuously monitoring the developing changes and stand ready to move to even more defensive positions should that become necessary. I do want to point out that fundamentally, we are nowhere near the kind of levels we have seen with previous bear markets. That is especially true with regards to the market meltdown in 2000. Stock valuation levels are far lower now, and cash holdings for companies are far higher. That means that companies are in a significantly better position to weather any economic pullback without having to cut jobs, which would add even more downward pressure.

The most important thing right now is to remain focused on the longer term picture, not the day to day fluctuations. We are anticipating the market will pull back over the next six months while the economy cools somewhat. We are also ready to then take advantage of those lower levels to put our cash reserves to work, and take full advantage of those lower prices.



# The Economic Picture

The US economy is most certainly slowing, which is really no surprise. What is a surprise is the rate of slowing that we are seeing, and the perception on behalf of the public that a recession is imminent. For better or worse, the general perception would appear to be that we are either heading toward or are already in a recession.

Technically speaking, a recession is defined as two consecutive quarters of negative GDP growth. A cursory glance at the GDP numbers to the right would show that we have quite a long way to slow down before we see negative numbers! However, as has been the case before, we may feel like we are in a recession even without the numbers providing confirmation.

As a result of this slowing, our economic analysis has shifted to show a move into a stage five environment. Stage five represents a contraction of growth, moving from say 4% per year to only 1% per year. While not technically an all-out recession, that slowing of growth can certainly feel like one.

The good news is that the Fed has finally admitted that they see the dangers, and stand ready to move aggressively if needed. The bad news is, that should have happened several months ago as it takes 6 to 9 months for Fed policy changes to filter into the broad economy. That having been said, traders are currently pricing in a definite 1/2% rate cut on January 30th, with better than even odds of a 3/4% cut at that meeting. Following that, the market is forecasting rates to be cut at each successive meeting until early

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

## Economic Indicators

	<u>Latest</u>	<u>Prior</u>
<b>Growth</b>		
<b>GDP</b>	<b>+4.9%</b>	<b>+3.8%</b>
<b>Productivity</b>	<b>+6.3%</b>	<b>+2.2%</b>
<b>Employment Cost Index</b>	<b>+0.8%</b>	<b>+0.9%</b>
<b>Capacity Utilization</b>	<b>81.5%</b>	<b>81.4%↓</b>
<b>Inflation</b>		
<b>Consumer Price Index</b>	<b>+0.8%</b>	<b>+0.3%</b>
<b>Core PCE Deflator</b>	<b>+0.2%</b>	<b>+0.2%</b>
<b>Implicit Price Deflator (GDP)</b>	<b>+1.0%↑</b>	<b>+2.6%</b>
<b>Sentiment</b>		
<b>Consumer Confidence Index</b>	<b>88.6</b>	<b>87.3</b>
<b>Unemployment Rate</b>	<b>+5.0%</b>	<b>+4.7%</b>
<b>Personal Income</b>	<b>+0.4%</b>	<b>+0.2%</b>

↑=revised up, ↓=revised down

Source: Moody's Economy.com

summer, landing us at a Fed Funds rate of 3.0% by June. The Fed Funds rate currently stands at 4.25%.

Finally, the markets are predicting that we will see the Fed Funds rate at 2.5% by next December. That would represent a drop of 1.75% from current levels, and bring us to a near zero real rate. The real rate is the actual rate minus inflation. The last time we saw that was back in late 2002 at the bottom of the post-dot-com bear market. Rates at that level have a definite stimulative effect on the economy. Hopefully, banks and other lenders have also learned their lesson and those low rates won't turn into a repeat of the excesses that led us to the sub-prime crisis in the first place.



Advantage Investing, Inc.  
Investment Strategy Composite Annualized Returns  
For The Period Ending 12/31/2007

<u>Investment Strategy</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>
Strategic Allocation Strategy	12.8%	15.5%	20.2%
Stock Strategy	13.5%	5.8%	9.4%
Bond Strategy	-0.4%	2.8%	8.0%
Current Income Strategy	-5.1%	1.7%	4.7%
 <u>Comparison Indices</u>			
S&P-500 Stock Index	3.5%	6.6%	10.1%
Dow Jones Corporate Bond Index	5.2%	3.4%	3.8%
US T-Bill Index	5.1%	4.3%	3.3%
Shearson Treasury Bond Index	10.0%	5.8%	4.7%

*Notes:*

*Composite returns are time weighted returns that include all client accounts invested within the respective strategy. Returns greater than one year in length are annualized. All strategy returns are shown net of all annual asset management fees, as well as all other trading expenses incurred. Past performance cannot guarantee future results.*

## Investment Strategy Review

### Stock Strategy

The Stock Strategy in 2007 had a tremendous year, beating the S&P-500 Stock index by an almost 4 to 1 margin! The strategy has benefitted greatly by a move from small cap and value stock investments and into large cap growth stocks as well as increased international exposure.

The current downdraft in stocks has indeed hit this strategy as well, but we have raised the allocation in cash to 20% of the holdings, sold off our remaining exposure to small cap stocks, and reduced our exposure to technology sector stocks. We are watching very carefully our international exposure at this time to see if we need to pull some of that money off of the table as well, locking in some of the significant gains we have seen there. However, at this time we are optimistic that those investments will be among the first to recover from the recent selling, so we will continue to hold them for the present.

### Strategic Allocation Strategy

The Strategic Allocation Strategy has long been our consistent winner, and the performance numbers above definitely back that up. This strategy also outperformed the S&P-500 benchmark by a nearly 4 to 1 margin. But even more impressive than that is that the five year annual return after fees is exactly double that of the benchmark. To put that in dollar terms, \$1,000 invested in the S&P-500 five years ago would have grown to \$1,617.84, while \$1,000 invested in the Strategic Allocation Strategy would have grown to an astounding \$2,509.13!

As with the Stock Strategy, we have recently been reducing our exposure to the technology sector as the economic forecasts have softened. In addition, we have increased the cash holdings to around 17% of the total, providing an even greater defensive posture. This strategy also has significant exposure to both utility stocks and international bonds, which both provide good upside diversification in slowing economic times.

### Bond Strategy

Since Advantage Investing was started almost 11 years ago in March of 1997, the bond strategy had never suffered a negative return in any calendar year - until 2007. The catastrophic effects of the sub-prime market collapse took their toll here as well. But please keep in mind that the loss was less than 1/2 of 1%, and even with that loss the five year average return is still more than double the Dow Jones Corp. Bond Index benchmark.

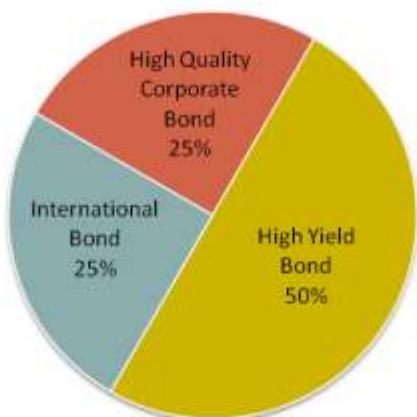
We have certainly made adjustments to the holdings within that strategy in order to reduce our downside exposure and position things more defensively. The exposure to the high yield bond market has been reduced by half, and we have added exposure to both high quality corporate bonds and international bonds.

I have spent quite a bit of time on conference calls with bond managers across the country to get a real handle on how they see the marketplace. By and large, they view this as a near-term weakness which provides the opportunity to buy

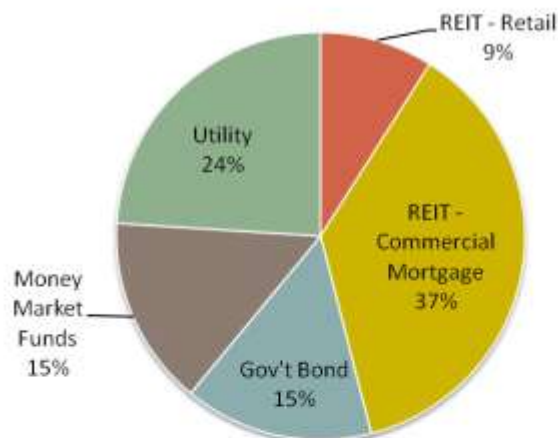
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# Current Investment Management Strategy Allocations

## Bond Strategy



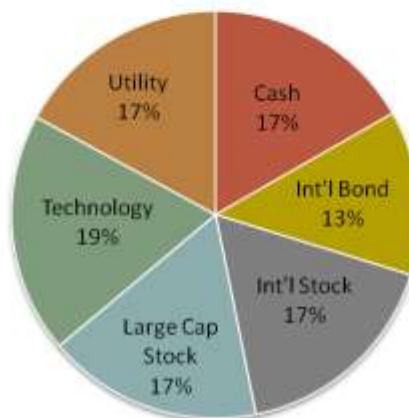
## Current Income Strategy



## Stock Strategy



## Strategic Allocation Strategy



*(Continued from page 3)*

good quality bonds at very low prices. The timeframes for a recovery in the credit markets have extended somewhat in recent months, but we have already seen many interest rate levels back down from their pure panic highs. Once the fear levels in the markets do finally relax, we should see returns on the scale of 2003, when in a similar environment the Bond strategy produced gains of 25% in that one year alone.

### Current Income Strategy

Last year was a very difficult one for the Current Income Strategy as well. The first half of the year was decent, as the strategy gained 2.7% after fees. It was the second-half that really brought on the difficulties as the strategy fell by 7.8% for a net loss of 5.1%. However, please note that the 4.7% five year average return is still well above the benchmark return of only

3.8% as well as the CD equivalent T-Bill return of only 3.3% per year. In addition, the current yield on this strategy stands at 7.0%, almost double the yield of the 10 Year US Treasury Bond. That means our investment holdings represent significant value and will be among the first to attract buyers as fear levels resolve.

As with our other strategies, we have increased the level of cash holdings invested in money market funds. The reason for this is twofold: The first is the general weakness of the overall markets. The second, one of our previous core holdings, Centerline Holding Corp., made a massive and sudden change to their business model and was no longer suitable for this strategy. Because of that, the position was sold. That stock is now 33% lower than where we sold it. Under normal circumstances those proceeds would have been reinvested in another high dividend paying stock. For now, however, we prefer to hold the higher level of cash and look for a better re-entry opportunity.