

The Advantage Advisor

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Market Commentary:

There is simply no other way to say it, September was an absolutely horrible month for the financial markets. The table to the right tells the story very clearly - and yes those are one month returns not one year returns. The fuel of panic settled on Wall Street in early September with the failure of Lehman Brothers and AIG. That fuel was then ignited, suddenly and furiously, by the United States House of Representatives as they failed to pass the Financial Markets Rescue Bill. The failure by the House led immediately to the single largest point drop in history for the Dow Jones Industrial Average as it fell by 778 points.

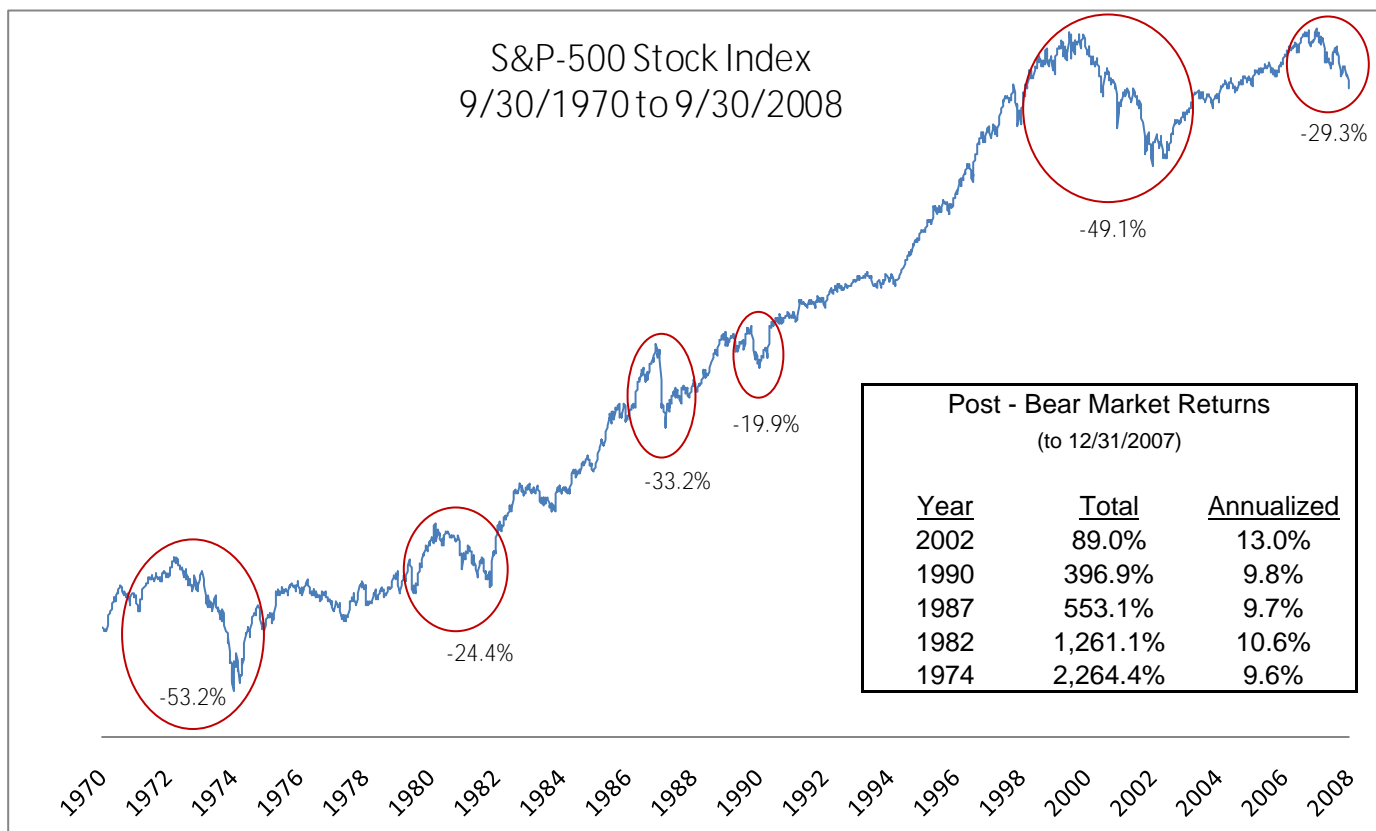
I must pause here, though, and say that I am sincerely grateful for our clients. While I did receive phone calls expressing concern about where things might be heading, there was no sense of panic in their voices. Their concern was centered more about the things their friends and co-workers were saying. That is very understandable given the headlines in the media talking about the next

Market Index	Closing Price	% Change
Dow Jones Industrial Average	10,851	-6.0%
S&P-500 Stock Index	1,165	-9.2%
Russell 2000 Stock Index	680	-8.1%
Shearson Treasury Bond Index	16,261	2.5%
Dow Jones World Stock Index	222	-12.7%
Nasdaq Composite Index	2,082	-12.1%

great depression. I certainly appreciate the fact that my own clients are much more level-headed than that.

The chart below should help to put the current market situation into a better perspective. What I have done is to chart out the growth of the S&P-500 Stock Index since 1970, highlighting each of the major bear markets over those years. Then, in the box inserted into the chart, I have calculated the gains in the market from the end of each of those bear markets up to the end of 2007. I chose that ending date very deliberately because it represents neither the previous market peak, nor the current market low.

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The Economic Picture

The Federal Reserve of the United States is charged with a dual mandate of price stability (controlling inflation) and full employment (economic growth). In order to protect against inflation, the Fed generally raises interest rates, and lowers them in order to promote economic growth. It has become thoroughly obvious that inflation is no longer a concern for our economy, but rather that growth has become the focal point. Therefore expectations for a Fed rate cut have grown tremendously over just the past few weeks.

The market's expectation of inflation can be measured by the TIPS Spread, shown in the chart to the right. As you can see, those expectations have dropped to around 1% over the near term and below 2% even in the long term. This expectation has been bolstered by falling energy and commodities prices, with crude oil back below \$95 and natural gas down almost 50% in just the last four months.

Lower inflation means that the Fed has even more room to cut interest rates. The current expectation is for the Fed to cut by a full 1/2% this month, and maintain that level all the way through July, 2009. Given the amount of damage that was done to the economy during September it is likely that we will see some grim reports over the next couple of months.

Interestingly enough, the economic reports for

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Current Economic Position:
Stage 5 - Contraction

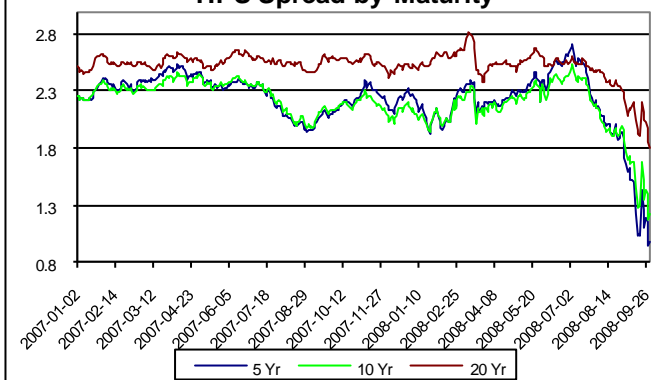
Economic Indicators

	Latest	Prior
Growth		
GDP	+2.8%↓	+0.9%
Productivity	+4.3%	+2.2%
Employment Cost Index	+0.7%	+0.7%
Capacity Utilization	78.7%	79.7%
Inflation		
Consumer Price Index	- 0.1%	+0.8%
Core PCE Deflator	+0.2%	+0.6%
Implicit Price Deflator (GDP)	+1.3%↑	+2.6%
Sentiment		
Consumer Confidence Index	59.8	56.9
Unemployment Rate	+6.1%	+5.7%
Personal Income	+0.5%	- 0.6%↑

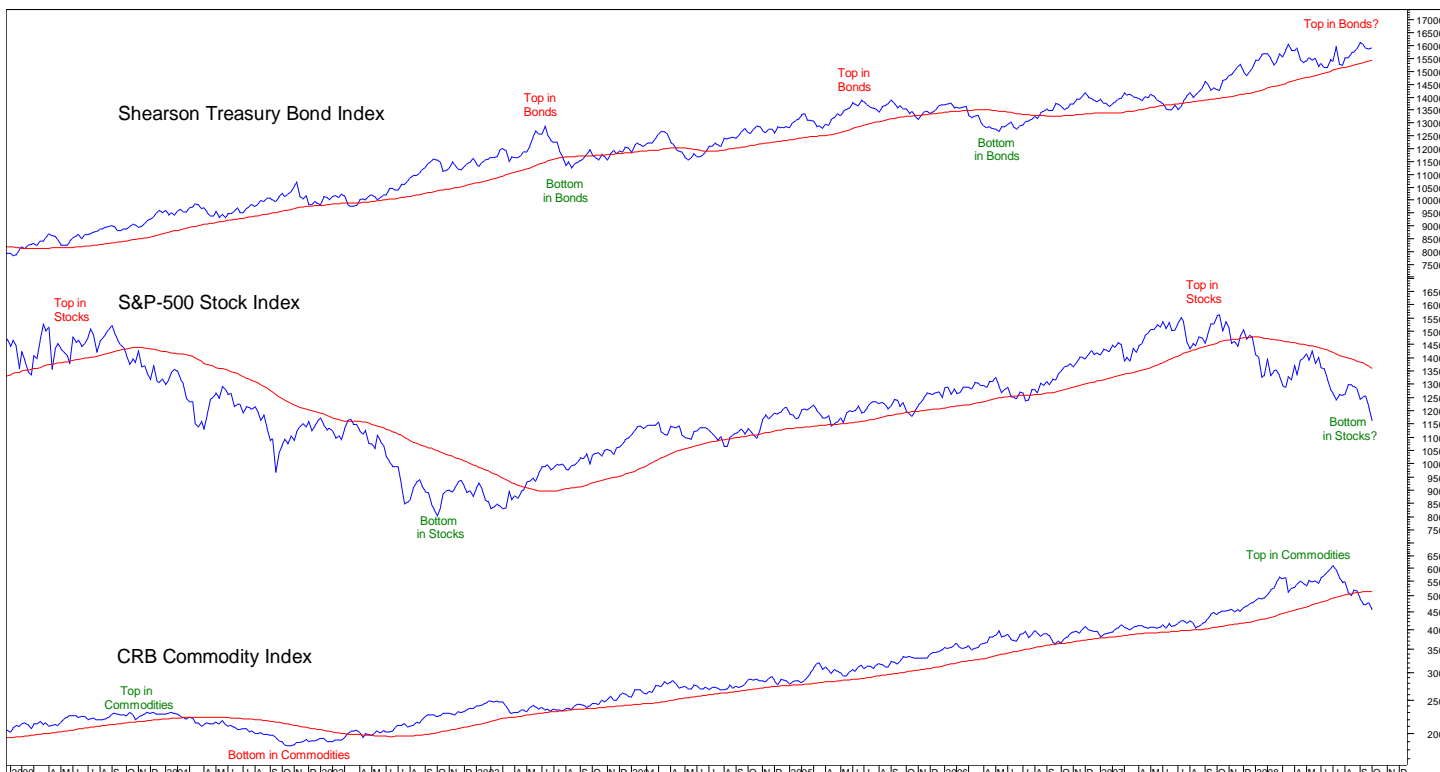
↑=revised up, ↓=revised down

Source: Moody's Economy.com

TIPS Spread by Maturity



Source for data: US Federal Reserve



Source for data: Investor's FastTrack

(Market Commentary, continued from page 1)

There are several features that quickly become apparent when one looks at this chart. The first of which is that our stock market has never failed to recover to new highs after any bear market. This is true even if one looks back all the way to the great depression. (In case you are wondering, the S&P-500 was not in existence during the bear market of 1929 to 1932. However, the Dow Industrial Average fell a total of 89.1% to a level of 41.6 during that period. As of 9/30/08 it stands 10,809 points higher than that low.)

Another striking feature is that our current bear market, as bad as it is, pales in comparison to the tremendous gains that the markets have provided over the years. And if you look at the returns that were realized after each of the bear markets shown, it certainly reinforces the idea that selling out in a panic at the bottom is exactly the wrong move to make. No matter which market bottom you pick, the subsequent annualized return was greater than 9.5% per year. In fact, the annualized return since the bottom in 2002 was 13%!

Yet one more intriguing feature is the unique grouping of these bear markets. As you can see, the trend appears to be that there is a large drop, followed by a smaller drop which occurs not long after prices recover above the prior peak. The second drop then appears to retrace about 2/3 of the preceding one, and subsequently recovers that loss very quickly (about 3.5 months on average). This is a purely technical observation, but if the trend does hold, then we are not only sitting right at the forecast low for this drop, but might also expect to see a recovery up to new highs by as early as next spring!

What we should take away from this, is that we should not allow ourselves to get pulled into the panic mentality of the crowd. The financial markets are very emotional places, and constantly swing from one extreme to the other. We've seen many of those swings take place in just the last month. However, in each of the three previous major bear markets (losses greater than 30%), all of those losses were recovered in just over four years on average.

Therefore, just staying invested in the markets has always been the better choice - especially if your portfolio is managed in such a way that it outperforms the market over the typical cycle. This is exactly the case with Advantage Investing's strategies. As you can see in table 1, each of these investment strategies either closely matched or exceeded their market benchmark returns over the last five years as well as since the end of 2001. Of course, past per-

formance cannot guarantee future results, but it is very obvious that our clients have fared significantly better than the markets - stocks and bonds alike. This is the benefit of active investment management.

Of course, staying calm and holding the course can be a difficult proposition in the midst of a public panic. Negative sentiment has reached unbelievable levels. My nine year old son asked me the other night if we were heading into another great depression! Clearly we are dealing with issues that have never been faced before - but that is the one constant through each of these bear markets. Every time, we were forced to face brand new obstacles and every time we overcame them and moved ahead.

So, now what do I do?

This is really the question on the minds of most investors. Now that we are here, in the midst of a bear market - what should I do? Here are some things that one should consider in order to relieve the stress of the moment:

1. Watch what the great investors are doing. Consider Warren Buffett, who in the past weeks has put more than \$10 Billion into the markets. That represents about 1/3 of the cash position of Berkshire Hathaway, his investment company. Buffett has been steadily building that cash up over the past several years, so it is very telling that he chose now to make such a large investment - with more likely to come.
2. Remember that the financial markets do not move

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*Table 1:
Advantage Investing Investment Management Strategies
Long-term returns versus their respective benchmark indices
(for the period ending 6/30/08)*

<u>Investment Strategy</u>	<u>5 Years</u>	Since <u>12/31/2001</u>
Strategic Allocation Strategy	15.8%	12.4%
S&P-500 Benchmark Return	<u>5.6%</u>	<u>1.7%</u>
<i>difference</i>	10.2%	10.7%
Stock Strategy	5.2%	3.2%
S&P-500 Benchmark Return	<u>5.6%</u>	<u>1.7%</u>
<i>difference</i>	-0.4%	1.5%
Bond Strategy	4.8%	7.6%
DJ Corp Bond Benchmark Return	<u>3.4%</u>	<u>5.8%</u>
<i>difference</i>	1.4%	1.8%

*** All returns are time weighted, annualized returns net of fees.*

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according to a fixed calendar. Thanks to the political calculations of the House, the markets sold off substantially at the end of September - right at the end of the 3rd quarter of the year. There are a lot of folks who only get a quarterly report of their 401(k) accounts, and will no doubt be very upset with what they see. Just recall the history of the markets, and that they are not tied to specific dates on the upside or the downside.

3. **Don't get caught up in the fear or political hype that is** so prevalent right now. I am constantly inundated with e-mails purporting to be conservative organizations which are trying to advance a noble cause. It is amazing to me how many of them are actually marketing strategies used by businesses or individuals that are simply trying to sell something. Remember that one of the biggest tools advertisers will use is emotion based - either selling into fear or greed.

Another example like this is a radio ad in my area by a mortgage broker, promoting the idea of liquidating investments in order to pay down your mortgage debt. This was, of course, the same guy who two years ago was selling 110% cash out mortgages to people in order to invest in the stock market and "...put that equity to work for you..." Following his advice the first time would have led you to cash out at the peak of the housing market, and invest near the top of the stock market. Following his advice now would lead folks to lock in their investment losses, compounding their real-estate issues that he caused! I'm sure the same broker will be happy to do the whole thing over again once the market turns around if anyone will still listen to him.

4. **Don't become a speculator.** When the markets are down, it is tempting to jump after an investment that promises huge gains in order to quickly recover your losses. Jumping out of a sound, long term strategy into speculative investments such commodities or the foreign exchange market is no wiser a choice than cashing out your investments and heading to Las Vegas or Atlantic City.
5. But what if I need money now? This is a common concern and a good question to ask. Remember that the key to making money in investing is to buy low and sell high, not the opposite. Also remember that the markets have always made their way higher, and there is no reason to think that will change now. So if you need to pull out some money for living expenses or for a significant purchase, it can certainly be done. However, you should try to use as little as necessary and consider putting off those larger purchases if

possible. Remember that every dollar you pull out of the market now is a dollar that cannot go back to work for you once the market recovers.

6. Finally, remember that investing much more about getting set for what will happen rather than what is or has happened. The temptation is to look at current conditions and believe that this is how it will remain, but that is never the case. Things will change and we will get through this rough spot.

Our Market Outlook

Our outlook on the markets at present is that we are sitting in a very precarious position. A tremendous amount of damage has been done to our economy and the financial markets thanks to the political posturing by our elected officials. While we may move lower over the short term, we do expect the markets to be higher than present over the next 12 to 18 months.

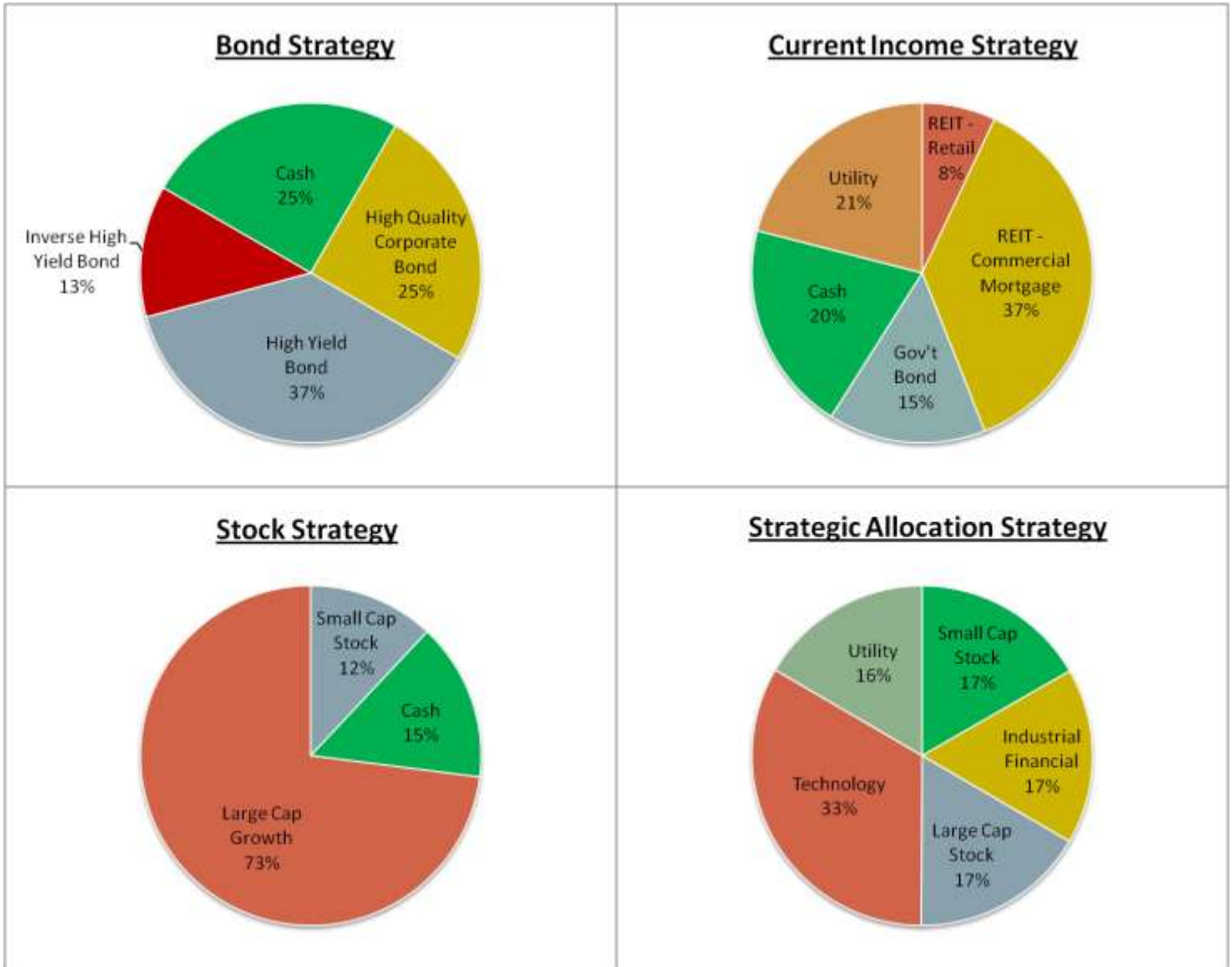
As an aside, I find it unconscionable that Congress would reject the financial rescue plan, sending the credit and financial markets spiraling down, then take two days off for a holiday, and then postpone the final House vote until after the vice-presidential debate! Clearly this shows where their priorities are.

Now that the rescue plan has been passed, we should start to see the credit markets begin to loosen up and move back toward normal operations. The next couple of months are likely to be a bit rocky as this process works its way out. We should also expect a couple of months of rather negative economic reports as a result of this whole fiasco.

Because of the uncertainty that will be present for the next while, we are pursuing a more defensive posture within our strategies. The Bond strategy currently holds the equivalent of 50% cash, 25% high yield bonds, and 25% high quality corporate bonds. The stage is set for the corporate and especially the high yield bond markets to see a strong recovery once the credit markets un-freeze. However, until that happens we will maintain a more neutral position, watching for the time to get that cash fully invested once again.

Our stock strategy holds about 15% in cash, and we have made some significant adjustments in our overall holdings in order to reduce our exposure to the riskier sectors, while increasing our potential for gains moving forward. We also stand ready to jump into an even more defensive posture very quickly should the environment deteriorate further from here. The same is true of the Strategic Allocation Strategy, though it holds slightly more aggressive positions at present.

Current Investment Management Strategy Allocations



(Economic Picture, continued from page 2)

August had been coming in stronger than expected. GDP growth, though revised downward, still posted a 2.8% gain for the second quarter. Personal income rose by more than double expectations. Worker productivity increased by a solid 4.3% while unit labor costs actually fell. And it even appears that home prices have stabilized and in some markets even posted a couple of months of modest gains.

The real concern now is the employment situation. Jobs and job security have a real impact on how people spend their money. If consumer spending continues to slow, we will indeed see GDP growth slip into the negatives and a technical recession. Because of this, we will likely see the economy move through a stage six recessionary environment rather than jumping past it as was previously hoped. Still,

the tremendous amount of central bank intervention may keep that recession relatively short and shallow. For example, jobless claims have been increasing in the 100,000 to 150,000 per month range, while in typical recessions those losses average more in the 250,000 to 300,000 per month range.

So there is good news and there is bad news. In general, our economy remains fragile, but positive. The global economy as well remains fragile. It is likely that the US will lead the way out of this downturn, but it is unclear at present just how soon that might be. It is likely things will slow a bit from here, before we make that final turn toward recovery and growth once again.