

# The Advantage Advisor

Volume 12, Issue 9

September, 2008

## Market Commentary:

I chose to delay writing this month's newsletter because of the incredible changes that took place on Wall Street during the 3rd week of September. The changes that have taken place in that one week will undoubtedly have ramifications reaching far into the future. We saw the failure of Lehman Brothers Holdings, an investment bank that actually pre-dates the civil war. Merrill Lynch was bought out by Bank of America, leaving only Morgan Stanley and Goldman Sachs as independent investment banks. Next, insurance giant AIG fell under attack and was rescued through a loan package backed by the Fed. And now finally Morgan Stanley and Goldman Sachs are being re-organized into bank holding companies.

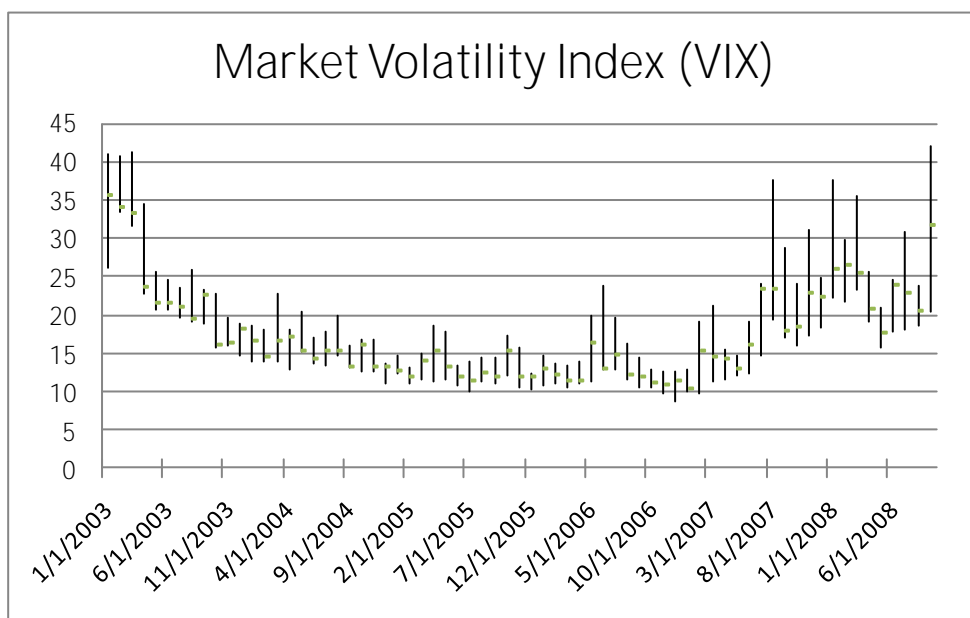
In just one week, every single one of the major forces on Wall Street has been changed forever. There have been other changes as well. The SEC put into effect a ban on the short-selling of financial companies. Other financial oversight agencies around the globe also put these bans into effect, and as a result we saw a tremendous rally take place as hedge funds rushed to close out losing short positions by buying back shares.

What is coming to light is a tremendous

Market Index	Closing Price	% Change
Dow Jones Industrial Average	11,544	1.5%
S&P-500 Stock Index	1,283	1.2%
Russell 2000 Stock Index	740	3.5%
Shearson Treasury Bond Index	15,864	2.5%
Dow Jones World Stock Index	254	-2.1%
Nasdaq Composite Index	2,368	1.2%

amount of price manipulation that has taken place through the use of unregulated financial instruments by hedge funds and other lightly regulated institutional investors. For example, a hedge fund would buy credit default swaps on the debt of AIG. These swaps were essentially insurance policies against the risk of default by AIG on their bonds. The tricky part was that the hedge fund **would not own any of AIG's debt, they just purchased the insurance.** Then, to pay for the insurance the fund would short sell the shares of AIG, meaning they would sell shares that they did not own either. The proceeds from the sale would fund the purchase of the insurance, which would rise in value because the shares of AIG were being constantly pushed downward, increasing the risk of a default on the debt.

All of this activity has driven the volatility in the financial markets to a level not seen since early 2003. However, this may not be all bad news. It was in early 2003 that stocks were finally able to reverse their long bear market and began the bull run that led us back up to new highs in both the Dow and the S&P-500. Without a doubt a tremendous amount of technical damage has been done, but even more signals are pointing to an end to the pain and the beginning of what could be a multi-year recovery.



(Continued on page 3)

# The Economic Picture

Our economic cycle analysis continues to point to a contraction stage rather than an all-out recession. Notwithstanding the recent credit crisis, the US economy appears to be maintaining slow but steady growth. GDP growth for the 2nd quarter was revised higher to 3.3% thanks to a significant increase in net exports. Exports from the US were helped by the weak relative value of the US dollar, which makes US goods and services cheaper for foreign buyers.

On the inflation front, the picture continues to improve dramatically. We can measure market expectations of future inflation by looking at the difference between the US Treasury securities and their inflation adjusted counterparts, known as TIPS. This measure, known as the TIPS Spread, can be seen in the chart to the right.

As you can see, the past two months have seen a significant shift downward in expectations. This is due mainly to the tremendous decline in commodities prices, as well as concerns over the health of the global economy. This drop in inflation expectations takes pressure off of the Fed where interest rates are concerned and opens the door for future rate cuts in order to provide further stimulus for the US economy.

Current Economic Position:  
Stage 5 - Contraction

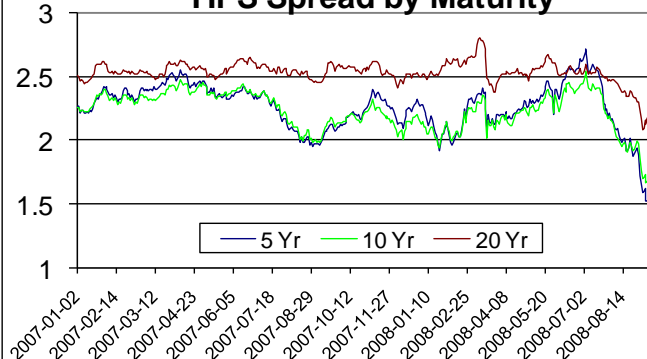
## Economic Indicators

	Latest	Prior
<b>Growth</b>		
GDP	+3.3%↑	+0.9%
Productivity	+4.3%	+2.2%
Employment Cost Index	+0.7%	+0.7%
Capacity Utilization	78.7%	79.7%↓
<b>Inflation</b>		
Consumer Price Index	-0.1%	+0.8%
Core PCE Deflator	+0.6%	+0.7%↓
Implicit Price Deflator (GDP)	+1.3%↑	+2.6%
<b>Sentiment</b>		
Consumer Confidence Index	56.9	51.9
Unemployment Rate	+6.1%	+5.7%
Personal Income	-0.7%	+0.1%

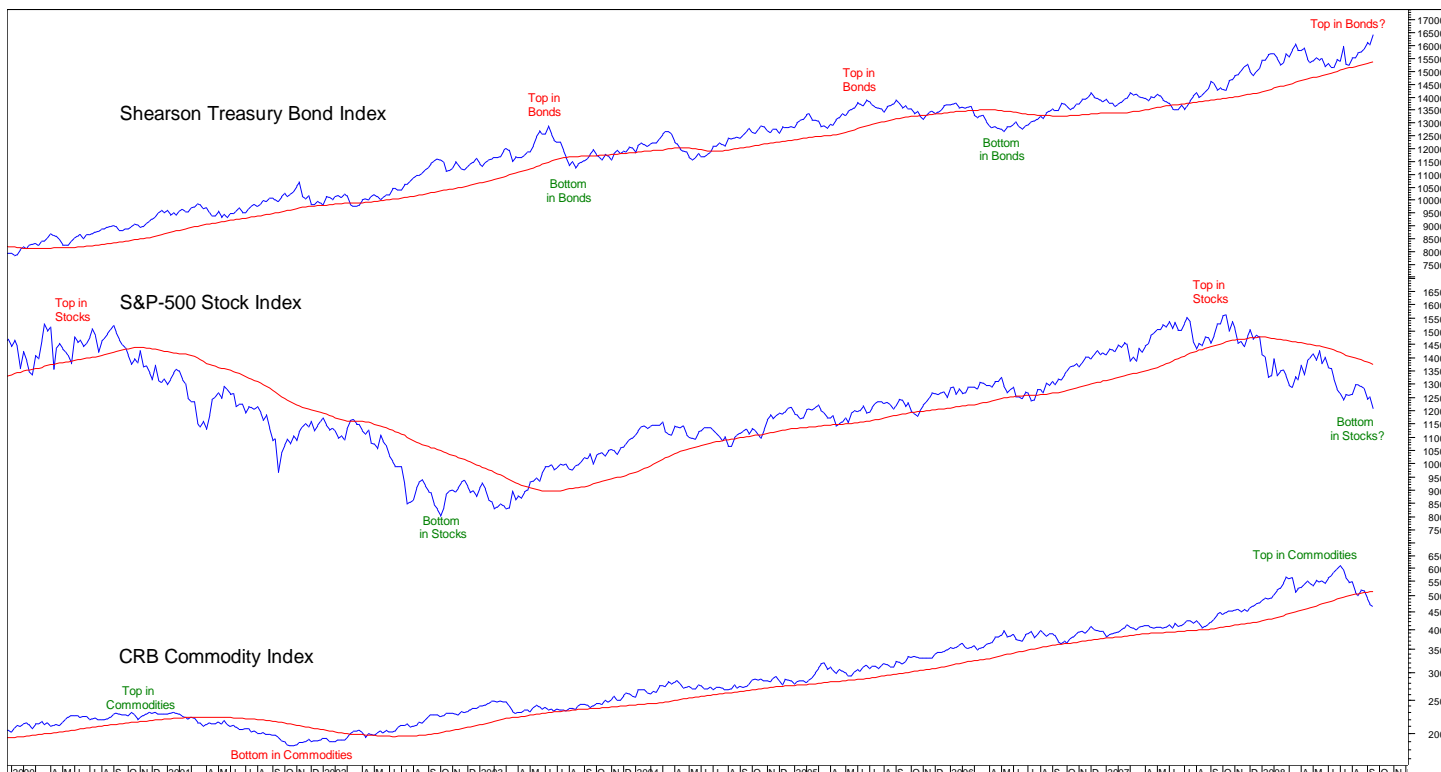
↑=revised up, ↓=revised down

Source: Moody's Economy.com

## TIPS Spread by Maturity



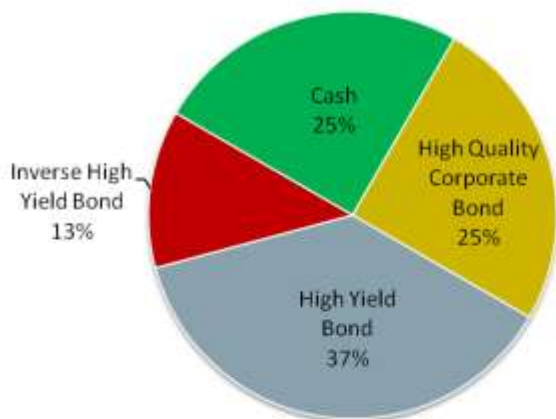
Source for data: US Federal Reserve



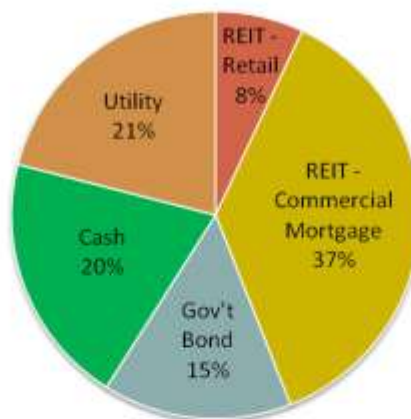
Source for data: Investor's FastTrack

# Current Investment Management Strategy Allocations

## Bond Strategy



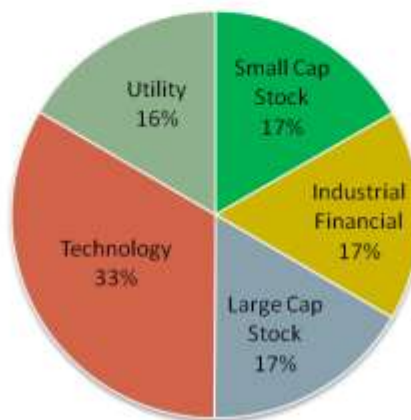
## Current Income Strategy



## Stock Strategy



## Strategic Allocation Strategy



*(Market Commentary, continued from page 1)*

To that end, we are managing our investment strategies with two overriding themes in mind. The first is to reduce risk wherever possible. That has meant a shift in our holdings away from international stocks as well as commodity and energy related sectors. It has also meant a temporary reduction in our exposure to the high yield bond market.

The other theme is to look for opportunities that will present themselves as the recovery unfolds. We have begun to wade into the small cap sector of the marketplace, as well as bolstering our exposure to technology issues. Both of these have tremendous potential to lead the way forward in the recovery. And while we have

temporarily reduced our high yield bond exposure, we continue to watch for a rebound in that sector similar to what we saw back in 2003.

Finally, one statistic of note: Looking back over the past seven years (since 2001), not one of our clients that continue to be served by us has a negative return in their account. In fact, even including the low point so far in September, on average those clients made almost *5% per year* more than the mere 0.4% annual return for the S&P-500! That is a track record we are proud of and hope that it helps to provide confidence to our newer clients as well.