

Confidence = Liquidity

When you have panic in the markets, like we have had this quarter, clients start to worry about every aspect of their accounts, including money markets. Before I write about what is happening in the markets and economy, let me point out a few things about our portfolios.

First, money markets and short-term debt instruments are safe as long as capital markets are functioning properly. With the lack of confidence currently in the markets, there was a run on money markets, much like the run on banks in the depression. To add confidence and stability in this market, the government is temporarily guaranteeing them. Once the credit markets go back to normal and banks start lending again, there will be no need for this guarantee.

Second, it is because of times like this that we do not take the risk of buying corporate bonds. We invest in the debt of the U.S. Government, their agencies or municipalities. If you have a balanced account, and you don't have any special holdings, you do not have to worry about receiving your principal when your bonds mature. Lastly, our strict buy and sell disciplines preclude us from owning companies that are not growing their earnings. This caused us to sell our bank and brokerage holdings over the past two years in the individual equity portion of our portfolios. The closest thing we have to a financial is General Electric which is an AAA rated company.

This is not to say that our portfolios haven't been impacted by this market. When there is panic selling, most equities lose value. Ours just haven't gone down as much over the past 2 years. The companies we hold look more attractive. Right now the average company we hold is projected to grow its earnings at over 14% and is trading for less than 15 times earnings. Once confidence returns, markets will start focusing on the longer-term and they will recover their lost value. The only question is, when will confidence return and the market's focus shift.

What caused the loss of confidence? Corporate greed, changes in accounting regulations and security trading rules created a perfect storm. It all started in the late 1990's when "The National Homeownership Strategy: Partners in the American Dream" was put into place. Lending regulations were loosened allowing individuals to buy homes with little credit and little or no money down. This prompted some lenders to lend money more

freely. As the profits from lending to these home buyers started rolling, greed took over and some lenders started taking more risk than they should. This risk was not only taken by the lender but also by insurance companies, mutual funds, individuals and anyone else that purchased these loans.

In 2006, while the irresponsible borrowing was going on, the Financial Accounting Standards Board issued SFAS 157 changing how companies valued assets on their books. Firms are now required to carry assets on their books at the price they would be worth if they had to sell them today rather than their long term value. When the housing bubble burst, high risk homeowners started to default. Confidence was lost in these investments and no one wanted to purchase any investment that might be linked to the housing market. Lenders were forced to carry loans on their books at a lower value than they were worth. In order to not violate lending covenants they had to raise capital.

Up until last year, in order to sell a stock short, you had to wait for the stock to go up. The Securities and Exchange Commission changed the rule allowing short sellers to drive a stock down without restrictions. Speculators knew that institutions had to sell stock to raise cash. These opportunists started acquiring short positions, driving the value of some companies down as much as 70 to 90 percent.

Confidence in financial markets eroded further. Credit markets seized up with no one willing to lend money to anyone. Without liquidity companies cannot function. The stock market started to sell off. Different branches of the Federal Government have stepped in to try and help stabilize the market. They helped find companies to takeover troubled financial institutions. They have taken over Fannie Mae and Freddie Mac. Short sales on financial stocks have been suspended. Finally, Congress is working on a plan to buy the financial instruments in question at a deeply discounted price to clean up the books of these companies so they can begin lending again.

Over time, confidence will return to the financial markets and liquidity will be restored. When it does, the markets will recover and patience will be rewarded.

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