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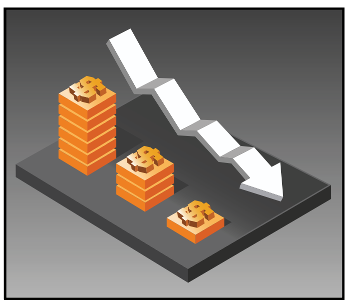
How Will We Know When The Credit Crisis Is Over?

When searching for the bottom of a bear market in stocks, experts often seek signs of "capitulation." That's the moment when almost everyone throws in the towel, selling in a panic. The notion is that all the bad news—about the economy, earnings, everything—is out there, and things could only improve. Now, as global markets suffer a seemingly endless credit crunch, it makes sense to look for the same kind of crucial juncture.



To find the end, consider the beginning. In 2003, the world economy had cash to burn. The U.S. federal funds rate, for lending among banks, had bottomed out at 1%, and interest rates around the globe had also dropped to near-record lows. As the economy began to pick up, all that cheap money was put to work in the form of business financing, consumer loans, and home mortgages—lots and lots of mortgages. Growing demand for real estate pushed up prices, and holding loans on fast-appreciating assets seemed safe and profitable. So investment banks began packaging mortgages into opaque securities that promised a steady stream of investment income.

It was those mortgage-backed investments, largely built around adjustable-rate loans to "subprime" borrowers, that ultimately spelled disaster. When rates on those loans jumped higher, homeowners began to default, and foreclosures flooded real estate markets with unsold homes. House prices declined, and the sinking value of mortgage-backed debt led to billions of dollars of losses at investment banks. To meet capital requirements, those institutions sold assets and invited investments by deep-pocketed outsiders. But each quarter brought more dismal news.

Last March, the U.S. Federal Reserve provided a $30 billion credit line for JPMorgan Chase to help it take over Bear Stearns, one of the nation's largest investment banks, which had been crippled by bad mortgage debt. The sale was accompanied by an announcement that the Fed would make funds available to other cash-strapped investment banks to help prevent additional failures.

Still, the drumbeat of multibillion-dollar losses continued. Investment banks, required to "mark to market" the worth of their portfolios, kept reducing the estimated value of their mortgage-backed debt. In July, Merrill Lynch sold collateralized debt obligations with a face value of $30.6 billion for just $6.7 billion, a move that guaranteed other banks, too, would take more huge write-downs.

As fall approached, the credit crisis intensified. One week into September, the government announced it was putting the two U.S.-sponsored mortgage behemoths, Fannie Mae and Freddie Mac, into federal receivership,

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Getting Back To Basics

We have always taken the approach that if an investment seems unnecessarily complex or opaque in nature, we prefer to forgo it in favor of plain vanilla securities. Some of these "new and improved" complex and opaque investments included collateralized debt obligations, auction rate securities, and hedge funds. While there are many variables in the market, many believe these types of investments exacerbated the extra-ordinary volatility we have experienced.

Given the stock market's precipitous decline, many have asked, "What are you telling people?" As always, our advice hinges on each individual's goals and needs. In general, though, we remind clients to focus on the basics: diversification and asset allocation to protect against the un-known, as well as liquidity to deal with the unexpected.

All are keenly aware that this has not been a fun time to be an investor, and diversification has not protected us against the broad sell-off we have experienced. However, we are cautiously optimistic and see opportunities emerging. We hope we can all look back five years from now and say, "We survived the crash of '08."

As we reflect on the recent holidays and the year gone by, we humbly thank you for continuing to show confidence in us and to make referrals so generously. There is no higher compliment.

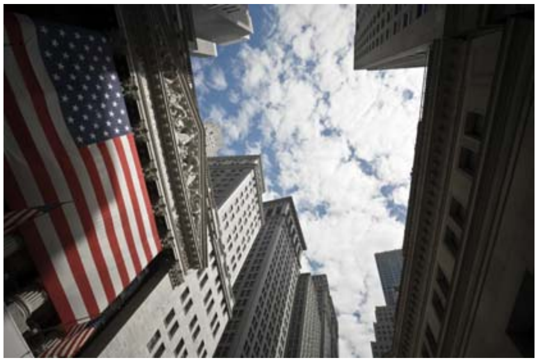
Judy

PS - Due to recent market volatility, Congress recently passed a law waiving RMD's for 2009. Consult your tax advisor or ask us for details.

After Wall Street Failures, A New Order

Last September, as stock prices plunged and one after another Wall Street institution had its day of reckoning, wealthy investors finally got mad. In a survey by Prince and Associates of Redding, Connecticut, 70% of clients at major Wall Street brokerages who had investable assets of more than $1 million said they wanted to fire their financial advisors, and nine of 10 were determined to pull at least some money from the brokerage accounts. Those percentages compared with 38% and 68%, respectively, just two months earlier. Although these firms have always dominated the money management business and handle more than five times the assets managed by independent advisors, this sentiment suggests real change could finally be at hand.

One reason, no doubt, was the failure of Lehman Brothers and the takeover of Merrill Lynch, as both investment banking giants found themselves crippled by their bets on mortgage-backed securities. Yet any shift toward independent advisors probably isn't the sole result of the latest turmoil. Time and again, large brokerages have failed to put clients' interests first, and this latest instance may have been the last straw for many investors.



The first problem was Wall Street brokerages' traditional business model. Their brokers earned commissions every time they bought or sold an investment for a client, and the firms structured compensation so brokers earned more selling whatever was most profitable for the firm. At times, the products they pushed, such as limited partnerships and variable life insurance, turned out to be terrible investments. It was a system rife with conflicts of interest that ignored what might be appropriate for a particular client.

Eventually, faced with competition from independent financial advisors who charged fees rather than commissions, gave impartial advice, and provided access to investments from a variety of sources, stockbrokers began to call themselves advisors and to offer slightly wider product choices. But then, earlier this decade, came another scandal, when mutual funds at several firms were caught favoring their own traders, hedge funds, and other major clients. Late trading, market timing, and front-running let investors on the inside increase profits at the expense of individuals.

Through all of this, the big firms' marketing managed to portray them as investors' allies. But this time, it really may be different. Wall Street companies took on so much inappropriate risk that they've been brought to their knees. And though they'll continue in some form, providing investment products and services, they may no longer dominate.

We are independent advisors not tied to Wall Street, and our goal is what it always has been—to help investors formulate and achieve their financial objectives. ●

Losing A Spouse, Always Trying, Also Presents Money Woes

The loss of a spouse, always traumatic, can be terrifying if your mate was the one who handled your family's finances. Suddenly you're facing a raft of unfamiliar issues. Will there be money to pay the bills? To get a handle on your situation, consider these suggestions.

Do your homework. If your spouse paid the bills, reviewed your bank and brokerage accounts, and did the taxes with your accountant, you have some catching up to do. Start by listing all your assets—your home and other real estate, insurance policies, cars, bank and brokerage accounts, and other valuables, and get a copy of your last tax return. Next, note your financial obligations—mortgage and car loans, other debt, utility bills, insurance premiums, and other recurring bills. To find everything, you may need to go through your check register and credit card receipts; they'll remind you of less common payments, such as quarterly outlays for property taxes or landscaping.

Get professional help. This is no time to go it alone. If your spouse worked with an attorney or accountant, get to know them; if not, ask friends for the names of competent pros who can help you assess your situation. As your trusted financial advisors, our office can "quarterback" and coordinate the work of your other advisors. If you need to make adjustments to your spending, long-term planning can help you find ways to save that are relatively painless. You'll need to assess the state of your investment portfolios—perhaps adjusting the asset mix to generate more income or save on

Lessons Of The Auction-Rate Securities Crisis

For most of this year, thousands of people have been unable to gain access to large sums of money they placed in investments they had been assured were “just like money-market funds.” But auction-rate securities are not just like money-market funds, a fact that became clear to most investors only after the market for these securities crashed in the throes of the credit crisis of 2008.

Federal and state authorities accused major Wall Street investment banks of continuing to sell auction-rate securities after it became clear the market was collapsing. After regulators threatened to take action against these firms—including Citigroup, UBS, and Merrill Lynch—and Congress scheduled hearings, the companies agreed to buy back the securities at full value and pay multibillion-dollar fines. The institutions deny allegations of wrongdoing.

As the wreckage was cleared away, investors can step back and consider lessons to be learned from this latest example of financial excess.

Since the introduction of auction-rate preferred shares in 1984, the market for the securities has grown into a $330 billion business. Investors have been attracted by normally quick access to their cash and interest rates that are generally higher than those of money-market funds and certificates of deposit.

Auction-rate securities typically consist of bundled corporate and municipal bonds with long-term maturities. The interest rates the securities pay are reset at weekly or monthly auctions, and because rates aren’t locked in for long periods, investors are never stuck with below-market yields. Moreover, because the issuers of these securities—ranging from mutual fund and student loan companies to nonprofit entities such as schools, museums, and municipalities—tend to be respectable groups looking to raise cash, auction-rate securities have been touted as solid and safe.

Trouble with the securities began when buyers, spooked by the widening credit crunch, fled complex investment instruments. With no one buying at the securities auctions, there was no cash to pay investors who wanted to withdraw their funds. Yet, according to allegations in numerous lawsuits, Wall Street firms not only kept selling auction-rate securities but also failed to warn clients about the danger.

The attorneys general of Massachusetts and New York began investigating the firms marketing auction-rate securities, and some of the larger firms have agreed to buy out their clients. That may sound like a happy ending, but the many investors who for months had no access to their money won’t be compensated for having their funds frozen.

State investigators allege that the firms encouraged analysts and brokers to gloss over potential dangers and push investments that were profitable to the firms, even at the expense of their clients. New York Attorney General Andrew Cuomo alleged that Citigroup repeatedly committed securities fraud by misleading investors into believing auction-rate debt was equivalent to cash and failing to reveal that the shares carried market-related risks.

The primary cause of risk in the market was the lack of a daily source of trading data on auction-rate securities, such as there is for Treasury bonds and stocks. Issuers had to rely on Wall Street dealers to function as buyers of last resort when bidders couldn’t be found, and the risk was that an economic crisis would leave the dealers without the financial ability to support the market. That’s exactly what happened. Big investment banks, already battered by failed investments in mortgage-backed debt, wouldn’t or couldn’t buy these securities.

Investors can learn several lessons from the auction-rate securities mess. The most important, of course, is *caveat emptor*. When Wall Street markets investment opportunities that seem to have an edge over similar products, it’s likely because there are hidden risks. Higher potential returns almost always come with higher risks, though that’s a warning that may be hidden in a fine-print disclosure if it’s made at all.

Our firm educates clients about all products, and if you don’t understand the risks of any of your investments, then please let us know. ●

But You Must Face Finances And Grief

taxes—and plan how to achieve your goals.

Watch that budget. If you do need to pinch a few pennies, start by making sure you’re taking advantage of today’s ultra-low interest rates. Refinancing your mortgage and car loan could mean substantial savings without affecting your lifestyle, and if you carry credit-card debt, you should shop around for a bargain-rate card. Next, consider postponing a few luxuries—a new car, an updated wardrobe, an extravagant vacation. And look for creative ways to save without feeling deprived. For example, instead of eating out, invite friends over and cook for them; you’ll enjoy the company and sidestep high restaurant prices.●

How Will We Know

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while Lehman Brothers, another pillar of Wall Street, desperately sought to sell itself. But now no one wanted to throw good money after bad. Lehman had to file for bankruptcy, and Bank of America rescued Merrill Lynch, which had also been on the brink of failure. Just one day later, the federal government put together an $85 billion loan package to prop up American International Group, a giant insurance company that had insured mortgage-backed investments for virtually all of the banks now on the ropes. If AIG, too, had gone down, it would likely have triggered a chain reaction of additional failures. The same week, the last two major American investment banks, Goldman Sachs and Morgan Stanley, announced that they were reorganizing as bank holding companies, a move that invites much closer regulation but could help them survive.

Yet even after all of this, credit markets still floundered, and the Bush administration announced it was working with Congress on a $700 billion plan to buy bad debt from financial institutions. As legislators wrangled and presidential candidates hovered, banks around the globe stopped lending. Capitulation, it appeared, was finally at hand.

Even if the giant rescue plans by the U.S. and other governments around the world manage to restore some confidence in the financial system, and banks resume providing the credit so essential to businesses and consumers, a lasting return to the days of easy money is unlikely. The U.S. will let more banks fail and be acquired, merely doing what it can to preside over an orderly rout. Major financial institutions will be larger, fewer, and much more tightly regulated. While that's not ideal for the long-term health of the economy after the crisis settles, if responsible borrowing and lending can resume, it will be a major improvement.

In the meantime, you should consider investing while prices are depressed to take advantage of the many buy-low opportunities available. Throughout history, the most successful investors are those who remain invested, and those who cash out during a panic often miss out.

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