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JANUARY 2008 COMMENTS

JANUARY 2008 MARKET ACTIVITY (ending Thursday January 31)

During January, each of the major US stock market indexes (S&P 500, Dow Jones Industrials, NASDAQ Composite), declined significantly, while high-quality US bond prices gained in value. International stock market indexes, both developed and emerging, also posted substantial declines. (See page 2 for all monthly and YTD figures).

These declines occurred in the context of the interconnected issues of: (a) continuing financial and credit problems leading to substantial losses at many major financial institutions; and (b) a US economy that slowed substantially in the fourth quarter of 2007. In an effort to improve the situation, the Federal Reserve lowered the short-term interest rates it controls twice during January, by a remarkable total of 1.25%, to a current level of 3%. Whether this, and other governmental actions, can overcome these problems in a reasonable time is the current major issue for the markets to resolve. This issue is discussed at length starting on page 5.

Since November, the Investment Concepts section of the Monthly Comments focused first on the reported reasons for the significant November price declines, and then, in December, on actions that can be taken by investors during periods when prices show substantial changes. For this month, we are going to put the current declines in the historical context of other significant price declines; then review the many points of view regarding the reasons for the problems; and finally discuss the likely prospects for their resolution.

FOOD for THOUGHT: (WSJ, 1/8/08, pg. A20, Global View column, by Bret Stephens):
“There is great virtue in the American way...in the belief that what is bad can be made good, and that what is good can be made great, and that what is fractionally less than great is downright awful. But these virtues can spawn vices. One is impatience. Another is a culture of chronic complaint. A third is the belief that every problem has a solution, that trial is possible without error, that risk must always be zero, that every inconvenience is an outrage, every setback a disaster and every mishap a plausible basis for a lawsuit.”

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Also Years 1999 – 2007, and Various Other Longer Time Periods
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Any recommendation contained in these Comments may not be suitable for all investors. Moreover, although the information contained herein has been obtained from sources believed to be reliable, its accuracy and completeness cannot be guaranteed.

COMMENTS: INDEX RESULTS for period ending JANUARY 2008

<u>STOCKS</u>	<u>YEAR</u> <u>1999</u>	<u>YEARS</u> <u>2000-02</u>	<u>YEARS</u> <u>2003-05</u>	<u>YEAR</u> <u>2006</u>	<u>YEAR</u> <u>2007</u>	<u>JAN</u> <u>2008</u>
Vanguard Total Stock Market Index Fund (1)	23.8%	(37.2%)	53.1%	15.5%	5.5%	(6.1)%
Standard & Poor's (S&P) 500 Index (2)	19.6%	(40.1%)	41.9%	13.6%	3.5%	(6.1)%
Vanguard S&P 500 Growth Index Fund (1)	28.8%	(48.4%)	41.8%	9.0%	12.6%	(7.9)%
Vanguard S&P 500 Value Index Fund (1)	12.6%	(26.2%)	63.2%	22.1%	0.1%	(4.1)%
Dow Jones Industrial Average Index (2)	25.2%	(27.5%)	28.5%	16.3%	6.4%	(4.6)%
NASDAQ Composite Index (2)	85.6%	(67.2%)	65.2%	9.5%	9.8%	(9.9)%
Vanguard Midcap US Index Fund (1)	25.0%	(18.3%)	83.9%	13.6%	6.0%	(6.5)%
Vanguard Smallcap US Index Fund (1)	19.6%	(24.2%)	87.5%	15.6%	1.2%	(6.2)%
Vanguard International Index Fund (EAFE) (1)	25.3%	(45.9%)	95.9%	26.6%	15.5%	(8.5)%
Vanguard Emerging Markets Index Fund (1)	61.6%	(29.5%)	162.7%	29.4%	39.0%	(11.1)%
Vanguard Real Estate Investment Trust Fund (1)	(0.4%)	47.5%	98.6%	35.1%	(16.5)%	(0.3)%
 <u>BONDS</u>						
Vanguard Total Bond Market Index (1)	(0.8%)	30.4%	11.1%	4.2%	6.9%	1.8%
Vanguard Intermediate Tax- Exempt Index Fund (1)	(2.9%)	23.7%	10.3%	4.4%	3.4%	1.6%
Vanguard Short-term Bond Index (1)	2.1%	25.8%	6.5%	4.1%	7.2%	2.0%
Vanguard Short Tax- Exempt Index Fund (1)	2.6%	13.8%	4.5%	3.2%	4.2%	1.1%
Vanguard High-Yield Bond Fund (1); starting 2002	NA	1.7%	30.7%	8.2%	2.0%	(0.7)%
Vanguard Inflation-Protected Bond Fund (1); starting 2001	NA	25.5%	20.0%	0.4%	11.6%	3.9%

NOTE: Three-year results start with a base of 100, and after each year's % change, the result for that year creates a new base. So if at the end of the first year the index is up 10%, then the new base is 110%; and if down 10%, then the new base is 90%. NOTE also that a decline of 50% requires a gain of 100% to get back to the starting value, which explains why NASDAQ, down 67%, would require a gain of 200% to get back to its starting value.

- 1) Results for Vanguard funds include dividends and fund expenses but do not reflect PPA's advisory fee.
- 2) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

%	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q			
		<u>1999</u>					<u>2000</u>					<u>2001</u>			
S&P 500	4.1	7.6	(7.7)	15.6	2.0	(3.0)	(1.3)	(7.8)	(12.1)	4.8	(13.8)	8.1			
NASDAQ	14.6	10.0	0.0	61.0	12.4	(14.8)	(7.2)	(29.6)	(25.5)	12.9	(26.7)	18.3			
BONDS	0.0	(0.5)	0.4	(0.7)	2.4	1.5	3.1	4.3	3.2	0.8	4.3	0.0			
		<u>2002</u>					<u>2003</u>					<u>2004</u>			
S&P 500	0.0	(13.8)	(14.1)	4.5	(1.8)	12.8	2.2	13.2	1.3	1.3	(2.4)	8.8			
NASDAQ	(5.5)	(19.5)	(13.5)	7.0	2.5	19.2	12.1	16.2	(0.5)	2.7	(7.5)	13.9			
BONDS	0.0	2.8	3.6	1.8	0.9	2.7	0.2	0.2	2.7	(2.6)	3.1	1.0			
		<u>2005</u>					<u>2006</u>					<u>2007</u>			
S&P 500	(2.6)	0.9	3.1	1.6	3.7	(1.9)	5.2	6.6	0.2	5.8	1.6	(4.1)			
NASDAQ	(8.1)	2.6	4.4	2.5	6.1	(7.6)	3.9	7.1	0.3	7.5	4.0	(2.0)			
BONDS	(0.5)	3.0	(0.7)	0.6	(0.7)	(0.2)	3.8	1.3	1.4	(0.6)	2.9	3.2			
		<u>2008</u>					<u>2009</u>					<u>2010</u>			
S&P 500															
NASDAQ															
BONDS															

JANUARY 2008 COMMENTS

STOCK index prices for US and international stocks posted substantial declines in January. The month's declines for a number of the indexes were greater than the full 2007 gains (see details in chart on page 2).

The broad-based US indexes of Total Stock Market, S&P 500, Dow Jones Industrials, and NASDAQ Composite declined in a range of -(4.6%) to -(9.9%). Many of last year's top performers, namely Emerging Markets, International, and US Growth had the largest monthly declines, whereas REIT, last year's worst performer, had the best (albeit still negative) monthly result. This is a common theme in investing, since no group outperforms other groups consistently over time.

BOND returns (price change plus interest) for the high credit quality part of the bond market were strongly positive for the month, as the Fed aggressively lowered interest rates. Monthly returns ranged from +1.1 to +2.0%, while Treasury Inflation Protected bonds, last year's big winner, continued its outperformance. The benchmark 10-year US Treasury yield closed at 3.64%, compared to December's 4.02%. Bond returns for various time periods are set out on page 2.

ECONOMIC NEWS impacting this month's price movements is discussed starting on pg. 5, as part of the review of the reasons for the market's recent extreme volatility, much of which has been to the downside.

From a longer-term standpoint, the major question now is whether the 2003-2007 recovery from the severe bear market of 2000-2002 is over, or whether stock prices can regain their long-term positive direction. Looking back over the full period from the 2000 highs to January 2008, the Dow Industrials are 8% higher, the S&P 500 10% lower, and the NASDAQ still a stunning 53% lower. Thus, the annualized returns for all three indexes since 2000 are far below their long-term average annualized returns. The mutual fund company Vanguard notes that from 1926 through 2005, in only six of 80 years did stock prices fall within 2%, up or down, of the long-term annual average return of plus 10.4%.

However, going back further to the bull market that began in 1995, all three major indexes have remarkably similar average annual returns, all positive, ranging from 8.8% to 9.5%. (They are, however, below the 10.4% average annual return for stocks dating back to 1926.) As these returns converge, "regression to the mean," described by Swensen as "one of the most powerful influences in the world of finance" (pg. 154), seems apparent. But Vanguard's observation is also meaningful, since annual returns during the bull market were far higher than the long-term averages, and the eight year returns from 2000- 2007 have been far lower.

The moral: Stock returns are truly unpredictable and volatile in short time frames, and can be over long time periods as well, even with (so far) a fairly stable very-long-term average return. Key Questions: Your relevant time frame and tolerance for risk.

	<u>S&P 500 (1)</u>		<u>DOW (1)</u>		<u>NASDAQ (1)</u>	
1st Qtr 2000 High	1,527		11,723		5,048	
Year End 2000	1,320	(13)%	10,785	(8)%	2,470	(51)%
September 21, 2001 Low	965	(37)%	8,235	(30)%	1,425	(72)%
Year End 2001	1,148	(25)%	10,020	(17)%	1,950	(61)%
October 9, 2002 Low	777	(49)%	7,286	(38)%	1,114	(78)%
Year End 2002	880	(42)%	8,342	(29)%	1,336	(73)%
Year End 2005	1,248	(18)%	10,718	(9)%	2,205	(56)%
Year End 2007	1,468	(4)%	13,265	+13%	2,652	(47)%
January 31, 2008	1,378	(10)%	12,650	+8%	2,390	(53)%

Context: Prior Five-Year Gains in Bull Market of 1995 - 1999

	<u>S&P 500 (1)</u>	<u>DOW (1)</u>	<u>NASDAQ (1)</u>
End 1994	459	3,834	752
End 1999	<u>1,470</u>	<u>11,500</u>	<u>4,070</u>
Gain	1,011	7,666	3,318
Avg. Ann. %Gain: '95-'99; 5 years	26.2%	24.6%	40.2%
JANUARY 2008	1,378	12,650	2,390
Gain	919	8,816	1,638
Avg. Ann. %Gain: '95-12/07; 13.1 yrs	8.8%	9.5 %	9.2 %

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's fees.

INVESTMENT CONCEPTS: CURRENT STOCK MARKET PRICE DECLINES

The chart below, which we introduced with our November Comments, has been updated to reflect the extreme volatility (mostly negative) of January.

	S&P 500	Change from YE06	Dow Jones Industrials	Change from YE06	NASDAQ	Change from YE06
YE 2006	1,418	-	12,463	-	2,415	-
7/19/07 High	1,553	9.5%	14,000	12.3%	2,720	12.6%
8/16/07 Low *	1,370	-3.4%	12,456	-0.1%	2,387	-1.2%
10/9/07 High	1,565	10.4%	14,165	13.7%	2,859	18.4%
12/31/07 Close	1,468	3.5%	13,265	6.4%	2,652	9.8%
1/22-23/08 Low *	1,270	-10.4%	11,635	-6.6%	2,202	-8.8%
1/31/08 Close	1,378	-2.8%	12,650	1.5%	2,390	-1.0%

* Note - Lows from 8/16/07 and 1/22-23/08 are not closing prices, but daily ("intra-day") lows

Some key observations from the chart:

1) From the 10/9/07 highs to the 1/22-23/08 intra-day lows, the S&P 500 was down 19%, the Dow Industrials down 18%, and the NASDAQ Composite down 23%. Those are major declines in a very short time frame.

2) However, just a week or so later, the recovery from those lows was also dramatic, with the S&P 500 gaining back 8.5%, the Dow 8.7%, and the NASDAQ 8.5%. Whether these gains continue or not is of course unknown, but the sharp recovery in a very short time frame illustrates the dangers of exiting the stock market after a period of declines, on the assumption the declines will continue.

We think it is worth putting the current declines in a historical context, along with the following observations:

1) Periods of significant declines invariably occur for sound reasons (see December 2007 Comments, and below, for discussion of the reasons for the current declines).

2) Current periods of declines seem more painful than prior declines, regardless of comparative magnitude, just because of the passage of time.

3) Current periods of declines invariably seem to point to additional and worse declines.

Since the most significant bear market for stock prices since the 1929-1932 stock market crash and Depression occurred in the three years 2000-02, it is worth reviewing that fairly recent history for some perspective on the current declines. From its January 2000 high, the S&P 500 declined 49% to its October 2002 low. It took until October 2007 for that index to regain its prior high, only to fall back again to its current levels, fully 10% below those 2000 highs. The comparable figures for the Dow Jones Industrial index are a decline of 38% from high to low, and then a recovery that took this index to a high of 20% above the previous 2000 high, and which is now 8% above that high. For the NASDAQ index, which suffered an almost incredible 78% decline from high to low; its best recovery level still left this index 45% below its previous all-time high, and it is currently 53% below its all-time high.

The declines of 2000-02 were clearly far worse than the current declines, and occurred over a much longer time frame. But of course the current declines have no discernible end at this time. Going back to the period of 2000-02, the initial major problem was that the prices of many stocks, and technology stocks in particular, reached levels that were unsustainable. Even Microsoft, at that time the great stock of the mid 1980s and 1990s, reached a price that was more than 50 times its earnings. Now, eight years later, Microsoft remains 40% below its all-time high. And it's important to remember that Microsoft actually earned significant profits during that time period; the real technology "bubble" came in the form of people paying huge prices for stocks with no earnings, many of which eventually went all the way to zero. In the midst of the overpriced stock market came the accounting frauds of Enron and Worldcom, and confidence in the stock market all but vanished. Also during this period, the US experienced the trauma of the 9/11 attacks (interestingly, stock prices at the end of 2001 finished higher than they were on September 10th, but then 2002 was the most significant single year of the three-year declines). And from those low levels of 2002, with conditions at their low ebb, stock prices recovered during the period 2003 through most of 2007.

Other significant declines were reported in a chart in the NY Times (1/18/08, pg. C1), all related to the Dow Jones Industrial index (1/11/73-12/6/74, down 45.1%; 11/29/83- 7/24/84, down 15.6%; 8/25/87-10/1987, down 36.1%; 7/16/90-10/11/90, down 21.2%; 7/17/98- 8/31/98, down 19.3%; and then the 2000-02 decline of 37.8% from 1/14/00-10/9/02). Each of these downturns had its own particular set of reasons for occurring. However, as we know from the long term history up to now, stock prices have recovered and provided positive average annual returns of approximately 10%, even with all these periods of decline. While this is not predictive of the future, it is a description of what has happened.

The current declines seem to have been triggered by a chain of events that started with an overheated, overpriced housing market. The high prices for homes gave rise to mortgages that proved too high relative to the underlying value of the homes, and whose interest rates started out low but had provisions for rapid increases. With housing prices declining, refinancing those mortgages was not possible, and so many defaulted. The investors who owned these mortgages (not the initiating banks, but entities that invested in the mortgages, possibly even thinking they were reasonably safe investments), wound up with major losses. Because many of these entities were banks, they began to tighten credit standards and restrict loans. This in turn had an adverse impact on the overall economy, as consumer spending slowed with reduced availability of mortgage funds to finance living expenses.

This at least is the scenario being presented by much of the media in its explanation of the current problems. However, what we have found in our extensive reading on the subject is that there are many points of view on both the causes and, more importantly, the likely outcomes of the current problems. We present some of these different points of view here to dispel the notion that everyone assumes the worst case will develop going forward.

The case for the downside is consistently and well presented by Floyd Norris, who writes regularly in the financial section of the NY Times. In a recent article (1/26/08, pg. B1), he writes that the sharp swings in the stock market “do not exactly inspire confidence, but rather fear. The Fed announced an emergency rate drop of $\frac{3}{4}$ of 1%, in a move that smelled an awful lot like panic. Economists were debating whether the economy was nearing a recession – or already in one. The NY State Insurance Superintendent sought a bailout of the major bond insurers, fearing disaster if they failed. Housing prices continued to drop. Further writedowns by major financial institutions seemed all but certain. All the things that the bears have been predicting were coming to pass, and it was hard to know when – or how – it would end....The collapse of credit is driving this recession....Private sector debt is beyond the economy's capacity to handle the debt....Are you ready to face a world in which your two biggest assets, your retirement account and your home, don't automatically go up?”

In an earlier article (1/13/08, front page), Norris and Peter Goodman write that “the economy is in a downward spiral, with each piece of negative news setting off the next. Falling housing prices have eroded the ability of homeowners to borrow against their property, threatening their ability to spend freely. Concerns about tightening consumer spending have prompted businesses to slow hiring, limiting wage increases and in turn applying the brakes to consumer spending. ...Employment, manufacturing activity, new home construction are all down, along with home prices....Banks have become protective of their liquidity and balance sheet capacity and thus have become less willing to provide funding to other market participants.” There have been many other articles with the same themes.

In the face of these very real problems, there are still some observers who make a positive case for the future. In a Wall Street Journal opinion article titled “The Economy is Fine (Really)” (1/28/08, pg. A15), Brian Westbury, Chief Economist from First Trust Portfolios, writes that “it is hard to imagine any time in history when such rampant pessimism about the economy has existed with so little evidence of serious trouble.” The article cites slowdowns in GDP, retail sales, industrial production, and the weakness in housing, but then counters that exports have grown rapidly, personal incomes are considerably higher, and corporate earnings, outside of the financial sector and certain large technology companies, are holding up well. “Yet many believe a recession has already begun because credit markets have seized up...and that an economic downturn, combined with a weakened financial system, will result in a perfect storm... for the US financial system....This outlook is both perplexing and worrisome. Perplexing because it is hard to see how a campfire of a problem can spread to burn down the entire forest...since an estimated \$100 billion loss on sub-prime loans, or even \$300 billion, represents only 0.1% to 0.3% of the \$100 trillion combined assets of all US households and US non-farm, non-financial corporations....The good news is that the US financial system is not as fragile as many of the pundits suggest. Nor is the economy showing anything other than normal signs of stress.... Because all debt rests on a foundation of real economic activity, and the real economy is still resilient, the current red alert about a crashing house of cards looks like another false alarm.”

A second positive opinion piece (WSJ, 1/29/08, pg. A17), was written by Steven Tattner, Managing Principal of a private investment firm called Quadrangle Group, and titled "Let's Get Real About the Economy." The writer begins by comparing this period with prior turmoil: "The early 80's, when wildly exuberant lending thrust a thousand savings and loans into insolvency; 1981, when the Federal Reserve drove its key interest rate to 19% in an effort to staunch inflation; the 1970s, when our economy was mired in stagflation; the dot com hangover, when the NASDAQ fell 78% amidst widespread corporate bankruptcies." He continues that while "the US economy is weak and getting weaker.... the probability remains that what our economy faces is less a plunge into the dark ages than a cyclical purging of excesses – perhaps akin to the eight-month recession of 2001....It is easy to understand the fear that has enveloped our financial system, a fear grounded in the complexity and lack of transparency associated with the rise of esoteric derivatives....But pronouncing the demise of the world's most productive economy is surely premature. Count among our blessings a flexibility that has kept inflation low and given the Federal Reserve the scope to reduce interest rates without triggering inflationary fears....While further stresses are inevitable as the adjustment process continues, our economic bedrock remains fundamentally strong."

An article in the NY Times Sunday Financial section (1/20/08, pg. 2) discusses the views of Citigroup's US chief equity strategist, whose statistical analysis of stock earnings multiples and bond yields leads him to the conclusion that stocks have reached price levels that have historically resulted in major gains twelve months later. The article discusses people's tendency to bail out of the market at bottoms, referencing the 2000-02 bear market, and the fact that people were selling at the low points, believing it would "take decades to recover," when in fact it took only five years.

Further, Ben Stein, who we have quoted frequently in prior Comments, wrote in a recent column (NYT, 1/27/08, pg. 7) that "stock traders have seized upon ... a stunning number of defaults and foreclosures in the sub-prime arena... and have tried, with the collaboration of their advance guard in the press, to make it seem like a total catastrophe so they could make money on their short sales....Note that the losses in the US markets alone are on the order of \$2.5 trillion in recent weeks. How can a loss of roughly \$100 billion on sub-prime, with some recoveries sure to come as property is seized and sold, translate into a stock market loss 25 times the size?...Stock traders are sending stocks down by a fantastically larger amount than is warranted by a recession or the losses in sub-prime." Jonathan Clemens, who writes investor columns in the WSJ, cited five reasons why stocks are attractive after the recent declines (1/23/08, pg. D1). And a WSJ article citing three major independent investment advisory firms stated that "the best move investors can make in the current roller coaster stock market: hold tight" (2/4/08, pg. R3).

Our view, as stated many times, is to rely on your established asset allocation, which is designed to limit your exposure to the downsides of stock prices consistent with the investment returns you need to reach your financial goals. And then stay with the program.



Victor Levinson



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