



# Park Piedmont Advisors LLC

Registered Investment Advisor

Helping to Achieve Clients' Goals with Indexed Investments

VICTOR LEVINSON

NICK LEVINSON, CFP®

## AUGUST 2008 COMMENTS

### AUGUST 2008 MARKET ACTIVITY (ending Friday, August 29th)

**US STOCK PRICES** showed modest gains in August, with continuing large daily price swings of more than 1%. This was the second consecutive month of modest price changes, following major declines in June. August's results ranged from +1.1% to +1.6% for the Total US Stock Market (which includes Midcap and Smallcap), S&P 500, NASDAQ Composite, and the Dow Jones Industrials. However, **International and Emerging Markets** continued their declines, at -(4.4%) and -(6.6%), respectively. Year-to-date (YTD) declines range from -(10.2%) for the US Total Stock Market to -(18.6%) and -(22.0%) for Total International and Emerging Markets, respectively.

**BOND PRICES** were slightly higher in August, and, combined with interest payments, bonds posted generally positive returns. However, certain income-oriented investments, namely commodities and currencies, were lower for the month, as oil prices continued to decline (based on weakening global economic growth) and the US Dollar gained in value.

Our basic position (abbreviated here) throughout the most recent period of financial turmoil and economic problems has been set out in previous Monthly Comments: "If the history of stock price recoveries is to repeat, the current problems need to be overcome.... There are no assurances or certainties here, only the knowledge that prior periods with significant problems experienced stock price recoveries." (A review of this history was presented in detail on pages 6-8 of June's Comments.) This remains our core view of the current situation, and why we advise our clients to stay with their current portfolio allocations.

### **IMPORTANT UPDATES:**

**Firm Brochure:** We have prepared a brochure that we will be distributing soon. We hope you take the time to review it, and consider referring us to people you know who are interested in working with an investment advisory firm that provides quality, low cost advice to help clients achieve their goals with indexed investments.

### **CONTENTS**

Page 1: Important Notices: What's in This Edition?

Pages 2-4: Index Results for AUGUST 2008, and Year-to-Date 2008;  
Also Years 1999 – 2007, and Various Other Longer Time Periods

Pages 5-8: Investment Concepts:

Pages 6-8: Investments We Use: Income-Oriented Investments

*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 AUGUST 2008**

	YEAR	YEARS	YEARS	YEAR	YEAR	YTD	AUG
<u>STOCKS</u>	<u>1999</u>	<u>2000-02</u>	<u>2003-05</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2008</u>
Vanguard Total Stock Market Index Fund (1)	23.8%	(37.2%)	53.1%	15.5%	5.5%	(10.2)%	1.4%
Standard & Poor's (S&P) 500 Index (2)	19.6%	(40.1%)	41.9%	13.6%	3.5%	(12.6)%	1.1%
Vanguard S&P 500 Growth Index Fund (1)	28.8%	(48.4%)	41.8%	9.0%	12.6%	(8.5)%	1.1%
Vanguard S&P 500 Value Index Fund (1)	12.6%	(26.2)%	63.2%	22.1%	0.1%	(13.5)%	1.4%
Dow Jones Industrial Average Index (2)	25.2%	(27.5%)	28.5%	16.3%	6.4%	(13.0)%	1.2%
NASDAQ Composite Index (2)	85.6%	(67.2%)	65.2%	9.5%	9.8%	(10.7)%	1.6%
Vanguard Midcap US Index Fund (1)	25.0%	(18.3%)	83.9%	13.6%	6.0%	(10.2)%	1.3%
Vanguard Smallcap US Index Fund (1)	19.6%	(24.2%)	87.5%	15.6%	1.2%	(3.8)%	2.9%
Vanguard International Index Fund (EAFE) (1)	25.3%	(45.9%)	95.9%	26.6%	15.5%	(18.6)%	(4.4)%
Vanguard Emerging Markets Index Fund (1)	61.6%	(29.5%)	162.7%	29.4%	39.0%	(22.0)%	(6.6)%
Vanguard Real Estate Investment Trust Fund (1)	(0.4%)	47.5%	98.6%	35.1%	(16.5)%	1.9%	2.2%
 <b><u>BONDS</u></b>							
Vanguard Total Bond Market Index (1)	(0.8%)	30.4%	11.1%	4.2%	6.9%	1.7%	0.6%
Vanguard Intermediate Tax- Exempt Index Fund (1)	(2.9%)	23.7%	10.3%	4.4%	3.4%	2.2%	1.2%
Vanguard Short-term Bond Index (1)	2.1%	25.8%	6.5%	4.1%	7.2%	2.7%	0.6%
Vanguard Short Tax- Exempt Index Fund (1)	2.6%	13.8%	4.5%	3.2%	4.2%	2.8%	0.4%
Vanguard High-Yield Bond Fund (1); starting 2002	NA	1.7%	30.7%	8.2%	2.0%	(2.6)%	0.6%
Vanguard Inflation-Protected Bond Fund (1); starting 2001	NA	25.5%	20.0%	0.4%	11.6%	5.1%	0.5%

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>			
<b>S&amp;P 500</b>	4.1	7.6	(7.7)	15.6	2.0	(3.0)	(1.3)	(7.8)	(12.1)	4.8	(13.8)	8.1			
<b>NASDAQ</b>	14.6	10.0	0.0	61.0	12.4	(14.8)	(7.2)	(29.6)	(25.5)	12.9	(26.7)	18.3			
<b>BONDS</b>	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>			
<b>S&amp;P 500</b>	0.0	(13.8)	(14.1)	4.5	(1.8)	12.8	2.2	13.2	1.3	1.3	(2.4)	8.8			
<b>NASDAQ</b>	(5.5)	(19.5)	(13.5)	7.0	2.5	19.2	12.1	16.2	(0.5)	2.7	(7.5)	13.9			
<b>BONDS</b>	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>			
<b>S&amp;P 500</b>	(2.6)	0.9	3.1	1.6	3.7	(1.9)	5.2	6.6	0.2	5.8	1.6	(4.1)			
<b>NASDAQ</b>	(8.1)	2.6	4.4	2.5	6.1	(7.6)	3.9	7.1	0.3	7.5	4.0	(2.0)			
<b>BONDS</b>	(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>			
<b>S&amp;P 500</b>	(9.9)	(2.9)													
<b>NASDAQ</b>	(14.1)	0.6													
<b>BONDS</b>	2.2	(1.1)													

## AUGUST 2008 COMMENTS

**STOCK** index prices posted modest gains for the month, but continued down substantially YTD (see details in the chart on page 2).

**BOND** returns (price change plus interest) were also modestly positive for August for high credit quality taxable and tax exempt bonds, and even lower-credit quality corporate bonds. The benchmark 10-year US Treasury yield closed at 3.82%, down 17 basis points (bps) from July, but still significantly higher than the low rate of 3.43% reached in March. The 10-year yield is almost 2% (200bps) higher than the Fed funds rate of 2%, which creates a yield curve that compensates investors for owning bonds with longer maturities. Note that as interest rates move higher, prices for existing bonds move lower. Certain income-oriented investments, such as commodities and currencies, were lower for the month. Our income-oriented investments will be discussed on pages 6- 8 of this month's Comments.

**ECONOMIC NEWS** continued mostly negative, with declines in employment and housing prices, and no relief from the financial losses and tighter credit associated with the mortgage and other credit problems. Some positive news came with oil prices continuing to decline, which could relieve inflationary pressures, and GDP was revised upward for Q2. However, GDP projections for the near term are lower, as the government rebates from earlier this year end.

From a longer-term standpoint, the housing and credit problems, the substantial rise in commodity prices, and the economic slowdown accompanying these problems have contributed to what is now a ten month stock market retreat from the October 2007 highs. The declines reached bear market territory during early July (defined by the major indexes falling 20% or more), and have effectively ended the 2003-07 recovery from the severe bear market of 2000-02. From the 2000 highs to August 2008, the Dow Industrials are (2%) lower, the S&P 500 (16%) lower, and the NASDAQ still a stunning (53%) lower. Thus, the annualized returns for all three indexes since 2000 continue to be far below their positive 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 similar average annual returns, ranging from 7.8% to 8.7%. (These returns are, however, well below the 10.4% annual average dating back to 1926.) As they converge, “regression to the mean,” described by Yale endowment manager David Swensen as “one of the most powerful influences in the world of finance” 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 returns from 2000-July 2008 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&amp;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)%
Aug 31, 2008	1,283	(16)%	11,544	(2)%	2,368	(53)%

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

	<u>S&amp;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%
AUGUST 2008	1,283	11,544	2,368
Gain	824	7,710	1,616
Avg. Ann. % Gain: '95-8/08; 13.67 yrs	7.8%	8.4 %	8.7 %

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

## INVESTMENT CONCEPTS

The chart below, which we introduced with our November 2007 Comments, has been updated monthly to reflect the extreme stock market volatility since the summer of 2007. The month of June, and extending into early July, marked a return to significant downside stock price volatility, which also characterized January through mid-March of this year.

	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, and 3/17 Lows*	1,257	-11.3%	11,635	-6.6%	2,155	-10.8%
5/31/08 Close	1,400	-1.3%	12,638	1.4%	2,523	4.5%
7/15 Low*	1,200	-15.4 %	10,828	-13.1%	2,167	-10.3%
8/31/08 Close	1,283	-9.5%	11,544	-7.4%	2,368	-1.9%

\* Note – all Lows are not closing prices, but ("intra-day") lows

Some key observations from the chart:

- 1) From the 10/9/07 highs to the most recent mid July intra-day low, the S&P 500 was down 23.3%, the Dow down 23.6%, and the NASDAQ Composite down 24.2%. These are major declines of bear market magnitude (in excess of 20%) in a matter of months.
- 2) The October 2007 recovery from the August 2007 lows, and the April-May 2008 recovery from the March 2008 lows, were both substantial, ranging from 10% to 20% in most cases, and occurring in very short time frames. These recoveries illustrate the dangers of exiting the stock market after a period of declines, on the assumption the declines will continue.
- 3) The June-mid July 2008 declines have, in one month, wiped away all the gains from April-May, and the recovery so far from these lows continues to be quite weak (approximately 6% to 8%).
- 4) There is no way to determine at what point the lows for this market cycle will have been reached until long after the cycle has been completed.

## **Investments We Use: Income-Oriented Investments**

We think it appropriate in this difficult economic and market environment to review the investments that we use in our clients' portfolios. This month's discussion will focus on income-oriented investments, and next month we will review stock investments.

Our definition of income-oriented investments goes beyond the category of bonds, and includes certain alternative investments that have a significant income component. They will be discussed in the section on alternative investments.

Some general principles apply to all Bond investments:

- 1) Bonds generally have less price fluctuation, up or down, than stocks.
- 2) Most of the investment return from bonds comes from the interest paid, not the price changes.
- 3) Price fluctuations are primarily a function of the following factors:
  - a) Changes in market interest rates on bonds that are issued after the bonds that are already owned in a portfolio;
  - b) Maturity of the bonds, i.e. the date when the amount borrowed is to be repaid;
  - c) Credit quality of the issuer, which reflects the likelihood of interest being paid and the amount borrowed being repaid at maturity.
- 4) These principles apply to bonds whose interest is taxable or tax exempt (the latter also known as municipal bonds)

The investments will be listed in the order of their likely degree of price fluctuation, starting with the least fluctuation and moving on to higher levels.

I. Money Markets. These investments are designed to have NO price fluctuation, because they mature in a very short time frame (average six months or less), and because they have high credit quality. Because there is no price fluctuation, the interest rates tend to be lower than any other category of income-oriented investment.

II. Certificates of Deposit (CDs). CDs are issued by banks with a stated interest rate for various time periods. The basic reason there is little price fluctuation is that each issuer's CDs are insured by the FDIC, up to \$100,000 for individual and trust accounts and \$250,000 for rollover accounts. Interest rates reflect market rates for the various maturities; the shorter the maturity, the lower the rate (see III below).

III. High Credit-Quality, Short-Term Bonds (maturities three years or less). The shorter the time to maturity, the less impact a change in market interest rates can have on the investment, because at maturity the bond issuer repays the investor the principal amount of the investment. Because of this reduced risk of adverse interest rate changes, short term bonds pay lower interest rates than longer term bonds. Assuming high credit quality and short maturities, there should be little price fluctuation for bonds in this category.

IV. High Credit-Quality, Intermediate-Term Bonds (average maturity six years). Consistent with the discussion in III above, these longer-maturity bonds have more price fluctuation, as they are more sensitive to changes in market interest rates, even assuming high credit quality. As a result, they generally pay higher interest rates than short term bonds

V. Inflation-Protected Bonds. These bonds pay a stated interest rate, typically quite low, and then make additional payments of principal based on government-reported levels of inflation. The original stated interest rate also applies to the increased principal amount. These bonds therefore address the major problem of inflation, which erodes the purchasing power of the bond's interest and principal over time. Although this inflation-protection feature should lead to relatively little price volatility, the reality of these bonds since their inception approximately ten years ago is that their prices are quite volatile, reflecting both inflation expectations and the typical ten year maturities at which they are issued. The fund we use (symbol VIPSX) owns US Treasury Inflation Protected bonds (TIPs), so there is no issue of credit quality.

VI. Preferred Stocks. These investments come with a fixed dividend rate, which must be paid before any dividends are paid on a company's common stock. Preferreds do not share in a company's profits, so, despite the name, their investment characteristics are much closer to bonds than stocks. Most preferred stocks are issued by banks and other financial institutions as a way to enhance their capital structure. Prior to the current financial problems, these preferred stocks were considered reasonably stable. That is no longer the case, however, as many issuers, notably Fannie Mae and Freddie Mac, have become major credit risks, both as to payment of dividends and repayment of the eventual principal. The maturities tend to be long, and when coupled with the recent credit problems, price declines have been substantial. Because of the price declines, current yields on these investments, with their fixed dividend rates, are quite high. For example, a preferred stock priced at \$25 when issued with a fixed 6% dividend would have a current yield of 7.5% if prices declined 20% to \$20. The primary investment we use for preferred stocks is an exchange-traded fund (ETF) (symbol PFF) that tracks a preferred stock index maintained by Standard and Poors.

VII. Commercial Mortgage Fund. Managed by Pimco, a well-regarded investment firm that specializes in income-oriented investments, this fund (symbol PCM) invests in commercial mortgages, which are another form of debt. The holders of mortgages receive interest payments along with portions of the principal, and eventually all the principal is supposed to be paid off. These mortgages are not on homes, but involve pools of mortgages on commercial establishments. Given the recent economic slowdown and credit problems, this fund has also experienced significant price declines; current yields range between 8 and 9%.

VIII. High Yield (or "Junk Bond") Funds. The bonds in these funds are acknowledged from inception to involve high credit risk, and the interest rates paid tend to be considerably higher than bonds with high credit quality. Note that there is a significant difference between this kind of investment, in which investors know from the outset that they are buying weak credits and are being compensated with significantly higher interest rates, and the preferred stock and commercial mortgage investments, in which investors expected reasonable credit quality. As we know now, subsequent events put that credit quality into question.

IX. Alternative Investment I - Commodity Fund. Also managed by Pimco, this fund (symbol PCRIX) invests in various instruments that provide exposure to the prices of such commodities as oil, metals, and agricultural products, and backed by a portfolio of inflation indexed securities. It is the yield associated with the inflation-protected bonds that has caused us to categorize this investment as income-oriented, even though the price volatility associated with the commodity investments is obviously much more like stocks than traditional bonds. However, even as the prices fluctuate, if they eventually reach some average level, the yield component should amount to a significant part of the overall investment return.

IX. Alternative Investment II - Declining Dollar Fund. Managed by Franklin Templeton, this investment (symbol ICPHX) uses money markets of various countries that the managers believe will maintain a favorable exchange rate versus the US dollar. The fund benefits when the value of the dollar is declining, and declines when the value of the dollar is rising. The income component comes from the yields earned on the various money market investments. But here again, the price volatility associated with the fluctuating value of the US dollar is clearly greater than the volatility associated with traditional bonds. However, as with the commodity fund, if the price fluctuations eventually average out, the yield from the various money market investments should provide a significant portion of the overall investment return.

In our management of the income-oriented portion of our clients' portfolios, we typically allocate between 60% and 80% to the high credit-quality investments, establishing a base of low price volatility and modest yields. The remainder of the income-oriented portfolio is designed to enhance the yield, understanding that additional price volatility is the tradeoff. A junk bond fund or preferred stock fund with a yield of 7%-8% or more, while coming with the risk of declining prices, at least promises interest/dividend payments of 7% or 8%. If prices remain stable, the interest payments provide a significant return. By comparison, to get a similar return, stock prices would have to go up 5-6%, which, combined with 2% average dividends, earns the same 7-8%.

Further, we typically use tax deferred retirement accounts to hold the higher yielding investments, as most come with interest taxed at the highest marginal rates. (The preferred stock investment also has a component of dividends taxed at 15%.)

This summary of the income-oriented investments we use is meant as an introduction to the subject. We welcome your comments and questions on this material.



**Victor Levinson**



**Nicholas Levinson**