Park Piedmont Advisors LLC

Registered Investment Advisor

Helping to Achieve Clients' Goals with Indexed Investments

VICTOR LEVINSON **NICK LEVINSON, CFP®**

OCTOBER 2008 COMMENTS

OCTOBER 2008 MARKET ACTIVITY (ending Friday, October 31st)
During the month of October, STOCK prices experienced double digit declines, in one of the worst months on record. Added to the already substantial declines that had occurred through September 2008, the YTD declines exceeded 30% for US stocks, and were even larger for international and emerging markets stocks.

BOND prices were mixed, but most corporate bonds, regardless of credit quality, and even inflation-protected US Treasuries, declined substantially. Prices of municipal bonds and preferred stocks (the latter investment having experienced significant declines through September) held up better than other income-oriented investments. Commodity prices fell dramatically, in reaction to the perception of a substantial worldwide economic slowdown.

This month's discussion section contains ten pages (5 to 14), focusing on: (1) October's historic results; (2) views on causes of the problems; and (3) views on the future.

IMPORTANT NOTICES:
Park Piedmont ADV and Privacy Statement You can request the most current version of our ADV by contacting Lynette. Our Privacy Statement is enclosed.
NEW ADMINISTRATIVE OFFICES After a number of years happily sharing space with Richard Backer, CPA, at 110 West 40th Street, in New York City, we are moving to 1034 River Road, Suite # 4, Edgewater, New Jersey, 07020. We will advise you of our phone and fax numbers at the new location as soon as possible. The move is scheduled to take place during December. Nick and I will continue to work from our respective home offices.
Required Minimum Distributions from Retirement Accounts (RMDs)
All clients who reach 70 1/2 years of age during 2008 must take an RMD. You should receive a letter from either Schwab or National Financial Services (NFS), depending on the firm that serves as custodian for your retirement account, regarding the amount. We will be in touch with you as to how you want to receive your RMD.
Annual Fee for Retirement Accounts For retirement accounts still at NFS, there is a $35 annual charge. You will receive a letter on this, and we suggest letting NFS debit your account rather than bothering to send a separate check.

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COMMENTS: INDEX RESULTS for period ending OCTOBER 2008

	YEAR	YEARS	YEARS	YEAR	YEAR	YTD	OCT
STOCKS	**1999**	**2000-02**	**2003-05**	**2006**	**2007**	**2008**	**2008**
Vanguard Total Stock Market Index Fund (1)	23.8%	(37.2%)	53.1%	15.5%	5.5%	(32.9)%	(14.4)%
Standard & Poor's (S&P) 500 Index (2)	19.6%	(40.1%)	41.9%	13.6%	3.5%	(34.0)%	(13.3)%
Vanguard S&P 500 Growth Index Fund (1)	28.8%	(48.4%)	41.8%	9.0%	12.6%	(33.3)%	(14.3)%
Vanguard S&P 500 Value Index Fund (1)	12.6%	(26.2)%	63.2%	22.1%	0.1%	(32.8)%	(13.3)%
Dow Jones Industrial Average Index (2)	25.2%	(27.5%)	28.5%	16.3%	6.4%	(29.7)%	(11.5)%
NASDAQ Composite Index (2)	85.6%	(67.2%)	65.2%	9.5%	9.8%	(35.1)%	(13.6)%
Vanguard Midcap US Index Fund (1)	25.0%	(18.3%)	83.9%	13.6%	6.0%	(38.9)%	(17.1)%
Vanguard Smallcap US Index Fund (1)	19.6%	(24.2%)	87.5%	15.6%	1.2%	(31.6)%	(18.8)%
Vanguard International Index Fund (EAFE) (1)	25.3%	(45.9%)	95.9%	26.6%	15.5%	(44.8)%	(15.6)%
Vanguard Emerging Markets Index Fund (1)	61.6%	(29.5%)	162.7%	29.4%	39.0%	(52.7)%	(18.1)%
Vanguard Real Estate Investment Trust Fund (1)	(0.4%)	47.5%	98.6%	35.1%	(16.5)%	(30.0)%	(31.8)%
BONDS							
Vanguard Total Bond Market Index (1)	(0.8%)	30.4%	11.1%	4.2%	6.9%	(1.9)%	(2.5)%
Vanguard Intermediate Tax- Exempt Index Fund (1)	(2.9%)	23.7%	10.3%	4.4%	3.4%	(1.7)%	0.1%
Vanguard Short-term Bond Index (1)	2.1%	25.8%	6.5%	4.1%	7.2%	1.5%	(0.1)%
Vanguard Short Tax- Exempt Index Fund (1)	2.6%	13.8%	4.5%	3.2%	4.2%	2.7%	0.4%
Vanguard High-Yield Bond Fund (1); starting 2002	NA	1.7%	30.7%	8.2%	2.0%	(22.6)%	(14.0)%
Vanguard Inflation-Protected Bond Fund (1); starting 2001	NA	25.5%	20.0%	0.4%	11.6%	(7.8)%	(8.9)%

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
		1999				**2000**				**2001**		
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
		2002				**2003**				**2004**		
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
		2005				**2006**				**2007**		
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
		2008				**2009**				**2010**		
S&P 500	(9.9)	(2.9)	(7.9)									
NASDAQ	(14.1)	0.6	(8.0)									
BONDS	2.2	(1.1)	(0.5)									

OCTOBER 2008 COMMENTS

STOCK index prices went into freefall in October, recording some of the worst monthly declines since the 1930s (specific fund results are reported on pg. 2; a general discussion of the severity of these declines, and contributing factors, begins on pg. 5).

BOND returns (price change plus interest) continued to be adversely affected by the severe credit problems permeating the world's financial system. Prices declined for high credit quality taxable bonds, including the previously high performing inflation-protected bond fund. Lower-credit quality securities declined even further, in amounts approaching those of stock prices. The benchmark 10-year US Treasury yield closed at 3.99%, a modest 15 bp increase from September, but hardly a reflection of the turmoil in the broader corporate and international credit markets. (The recent low rate on this bond was 3.43%, reached in March). Note that, in general, as interest rates move higher, prices for existing bonds move lower (see details in the chart on pg. 2).

ECONOMIC NEWS continued mostly negative, with ongoing declines in employment, housing prices, retail sales, consumer spending, and durable goods orders. The preliminary GDP for Q3 was negative (0.3%), a clear sign that a recession is at hand. The key question now is its duration and severity, which is spreading internationally as well. Massive losses in a wide variety of credit-related transactions has led to governments buying direct stakes in major financial institutions, in the hopes of restoring market stability and getting the banks to resume their normal lending activities. One piece of positive news was the continuing declines in oil prices, which could relieve inflationary pressures. But governments' huge infusions of money into various programs designed to reignite economic activity is likely to be inflationary going forward (more on this on pg. 11).

From a longer-term standpoint, the housing and now much more widespread credit problems have triggered an economic slowdown that in turn has created a significant bear market for stocks (detailed discussion starts on pg. 5). The 2003-07 recovery from the severe bear market of 2000-02 has ended, and the 2008 price declines have now essentially wiped out all the stock price gains from the past five years. From the 2000 highs to October 2008, the Dow Industrials are now 20% lower, the S&P 500 37% lower, and the NASDAQ a stunning 66% lower. This is likely to be the first decade since the 1930s with cumulative annualized negative stock returns, making these returns obviously far lower than 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%.

Going back to the bull market that began in 1995, all three major indexes have similar (and after the past two months, much lower) average annual returns, ranging from 5.5% to 6.6%. (These returns are obviously far 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 from 1995-99 were far higher than the long-term averages, and the 2000-08 returns are negative.
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.

	S&P 500 (1)		DOW (1)		NASDAQ (1)	
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)%
October 31, 2008	969	(37)%	9,325	(20)%	1,721	(66)%

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

	S&P 500 (1)	DOW (1)	NASDAQ (1)
End 1994	459	3,834	752
End 1999	1,470	11,500	4,070
Gain	1,011	7,666	3,318
Avg.Ann.%Gain:'95-'99; 5 years	26.2%	24.6%	40.2%
OCTOBER 2008	969	9,325	1,721
Gain	510	5,491	969
Avg.Ann.%Gain:'95-10/08; 13.83 yrs	5.5%	6.6%	6.2 %

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. However, what appeared to be extreme volatility prior to September and October 2008 has turned out to be a mild prelude to the declines of the last two months. The chart reflects this fact well.

	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%
10/10,and 10/24 Lows*	840	-40.7 %	7,882	-36.7%	1,494	-38.1%
10/31/08 Close	969	-31.7%	9,325	-25.2%	1,721	-28.7%

* Note – these 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 October lows, the S&P 500, Dow Industrials, and NASDAQ Composite were all down in a range of 44% to 48%. These declines have now exceeded the declines of the 1973-4 and 2000-02 bear markets.

2) The October 2007 recovery from the August 2007 lows, and the April-May 2008 recovery from the mid March lows, were both substantial, ranging from 10% to 20% in most cases, and occurring in very short time frames. Even the recovery during the last week in October exceeded 10%. These recoveries illustrate the dangers of exiting the stock market after a period of declines, on the assumption the declines will continue. However, we do know now, with the benefit of hindsight, that each of these rallies was modest, given the extent of the declines that have followed.

3) Even knowing what we know now about the severity of this bear market, there is no way to determine, before the fact, at what point the lows for this market cycle will have been reached until long after the cycle has been completed.

MARKET ACTIVITY IN OCTOBER 2008

This month's Comments are written with a clear understanding that we are reporting on historic events, not as historians with the advantage of hindsight, but as participants, very much caught up in the day-to-day unfolding of totally unexpected and unprecedented events. Accordingly, these Comments have taken longer than usual to prepare, as we are intent on providing what we hope will be reasonable reporting in the midst of chaotic times.

We will begin with a review of October's market activity, then move on to a discussion of the many factors reported to be at work in creating the conditions for the declines, and finally present some observations on the possible future direction of this crisis.

October's Market Activity: STOCK PRICES

During the first eight trading days, ending Friday, October 10th, the Dow Jones Industrial Average (DJIA) declined 2,400 points, or 22%; the S&P 500 declined 266 points, or 23%; and the NASDAQ Composite declined 432 points, or 21% (based on closing prices, not intra-day lows). According to the WSJ front page story, "Wild Day Caps Worst Week Ever for Stocks," (10/11-12/08) "this week's 18% decline, and Friday's 1,018 point swing from low to high, were the biggest since the Dow was created in 1896." So there is no hyperbole in our observation that we are reporting on historic events.

By virtue of a substantial rally during the last week of October, stock prices were higher at month-end than at the October 10th close. However, this end of the month result masked enormous price swings. For example, on Monday, October 13th, the DJIA gained 936 points, or 11.1%, only to see these gains disappear by the close of October 27th, from which point stock prices gained over 10% to finish the month. We are talking about price swings in a day or week that often make up a full year's price change. The full month declines amounted to -(11.5%) for the DJIA, -(13.3%) for the S&P 500, and -(13.6%) for the NASDAQ. The Total Stock Market index, which includes Midcap and Smallcap stocks, was down -(14.4%) for October. The YTD figures for these four US stock market indexes were as follows: -(29.7%), -(34.0%), -(35.1%) and -(32.9%) respectively.

October was even less kind to other broad based stock indexes that make up portions of our clients' portfolios. The developed country international index declined -(15.6%) for the month, and is down -(44.8%)YTD; the emerging markets index declined -(18.1%) for the month, and an even more striking -(52.7%)YTD; and the REIT index, which had been one of the few parts of the stock market up through September, caught up to all the other decliners in October, by declining -(31.8%), making its YTD decline -(30.0%). Two sectors that appear extensively in our clients' portfolios posted divergent results; on the relatively positive side was biotech, which although down -(12.0%) for the month was also down the same amount YTD; much worse was the result of the Alternative Energy fund, down -(29%) for the month and -(50%) YTD.

As you might expect, bellwether individual stocks also suffered. For example, GE declined -(23.5%) for the month and was down -(47.3%) YTD; Microsoft, -(16.4%) for the month and -(37.3%)YTD; and Bank America, -(31.0) for the month and -(41.4%)YTD. Two stocks that have done better than the indexes are Exxon Mobil, -(4.5%) for the month and -(21%)YTD and Pfizer, -(4.0) for the month and -(22.%) YTD. Apple and Google had relatively good months, down -(5%) and -(10%), but have declined -(45.6%) and -(48%) YTD.

October's Market Activity: BOND Prices (and other income-oriented investments)

The price declines for certain categories of bonds were in some ways as remarkable as the extent of the stock price declines. For example, the US Treasury Inflation Protected Bond fund, as "safe" an investment as there is, incurred a price decline of almost -(9%) in October, bringing its YTD price decline to over -(12%). This result is for bonds that have no credit default risk, as they are issued by the US Treasury, and whose interest rate risk should be covered by the periodic inflation adjustments. A second example of high credit quality bonds suffering large declines during October occurred with intermediate maturity corporate bonds, with well known names like General Electric, Coca Cola, and IBM. A Vanguard bond fund investing in these kinds of bonds declined -(7%) for the month and is down -(16%) YTD. Note that these figures are price declines only, without taking into account the interest paid on these bonds, which for these two bond groups approximate 6%-7% at current price levels. Therefore, the total return is higher than the price declines by the amount of interest.

Bond funds that have done relatively better for the month and year include high credit quality short- and intermediate-term taxable bonds with a mix of government and corporates, along with municipal bonds. The shorter the maturities, the better the performance.

Our client portfolios also include a category of income-oriented investments with lower credit quality securities that have had major price declines. The reason these investments were made was to try to obtain a higher income yield from the portfolio. Until this year, these investments worked as planned. But any low credit quality investment has had its price battered this year. For example, Vanguard's corporate high yield (aka junk bond) fund was down -(16%) in October and -(27.6%) YTD. Other investments that appeared to be of reasonable credit quality, but whose credit changed during this period of severe financial difficulties, include a preferred stock fund and a commercial mortgage fund. Interestingly, both of these investments had price increases during October, but were still down -(29%) and -(26%) YTD. Again, these price declines do not factor in the income received; on these investments, annual income should approximate 10%-12% based on current low prices.

Client portfolios also include a commodity fund and a currency fund that benefits from a declining US dollar. Both these investments would provide acceptable returns from their incomes only, but they are also subject to price changes. The commodity fund collapsed in October (think declining oil prices), down -(29%) for the month and -(40%) YTD, while the non-US currency fund has had much better results, down -(2%) for the month and -(4%) YTD. Adding the income received, this latter fund has a positive YTD return.

Possible Explanations for the Extraordinary Price Declines

For long time readers of our Monthly Comments, you know we are skeptical of attributing causation to market price movements. Most of the time, market price movements are modest, and can be considered random; even in times like these, where the direction of prices is clearly down, the reasons for the declines are complex, varied, and hard to prove with any certainty. However, since the media presents reasons in an ongoing flow of analysis, we think a summary of this material should be part of our discussion. You should note that the points we make are based on generalized themes, with specific events as part of those themes, rather than simply listing those events.

1) Declining value of a wide variety of debt securities, initially related to falling housing prices, causing huge losses for financial institutions and made worse by excess leverage.

"A successful plan to stabilize the US economy and prevent a deep global recession must do more than buy back impaired debt from financial institutions. It must address the fundamental cause of the crisis: the downward spiral of house prices that devastates household wealth and destroys the capital of financial institutions that hold mortgages and mortgage backed securities….The prospect of a downward spiral of house prices depresses the value of mortgage backed securities and therefore the capital and liquidity of financial institutions….The process of default and foreclosure leading to price declines and further defaults could take housing prices far below the long term sustainable level….As house prices fall, the value of mortgage backed securities would fall further. The impaired assets include not just mortgages but the complex derivatives based on those mortgages: the collateralized debt obligations, the various risk slices of those CDOs that, even if rated AAA, often have market prices close to 50% of their notional value. In addition, hundreds of billions of dollars of credit default swaps guarantee the value of mortgage backed securities." (Martin Feldstein, Chairman of the Council of Economic Advisors under President Reagan, and a professor at Harvard, from the WSJ, 10/4-5/08, pg. A15, in an article that also presents his plan to solve the problem of declining house prices).

"As the world economy reels under the weight of the worst financial crisis since the Great Depression, we have been left with a broken financial system. Financial institutions around the world have suffered life threatening, self inflicted wounds by purchasing over a trillion dollars of complex mortgage backed securities backed by dodgy loans based on inflated real estate values. These assets have been financed with enormous leverage and with short term debt….The long term solution to the present crisis must involve substantial de-leveraging and a recapitalization of our financial institutions. In the meantime credit has been essentially frozen and a worldwide recession seems almost inevitable (Burton Malkiel, Princeton professor and author of "A Random Walk Down Wall Street", from the WSJ, 10/13/08, pg. A19, in an article that advocates investors remaining invested in the stock market. That portion of the article will be discussed in a later section of these Comments, on pg. 13).

2) Lack of trust and confidence between financial institutions, and towards government policy makers, in the context of the potential insolvency of the financial system.

An NY Times front page article (continued on pg. 24), dating back to 10/1/08, even before the sharp stock price declines of October, states that: "The current, more serious stage of the crisis began two weeks ago today, after the collapse of Lehman Brothers and the Fed's takeover of AIG. Those events created a new level of fear. Banks cut back on making loans and instead poured money into Treasury bills, which paid almost no interest but also came with almost no risk. On loans they did make, banks demanded higher interest rates….Bankers are nervous that borrowers who look solid today may not turn out to be so solid. Also, bankers are nervous that other banks might stop extending short term credit,…and are hoarding capital, instead of making seemingly profitable loans….The crucial point is that a modern economy can't function when people can't easily get credit….Already a lack of car loans has caused vehicle sales to fall further."

The view of lack of trust towards policy makers is presented in the following article:

"Central bankers and government officials are dealing with a crisis of a scale not seen in most of their lifetimes, a crisis unfolding with terrifying speed and fueled by obscure financial instruments of almost unimaginable complexity and reach. There have been creative steps along the way, but also missteps that have eroded policy makers' credibility. The first occurred years ago…those in charge didn't just look the other way as Wall Street and Main Street loaded up on debt and risk, they egged the process on, as when Alan Greenspan touted adjustable rate mortgages at the height of the housing bubble….Then officials argued the damage to the financial system would be minimal….As the crisis gathered steam, policy makers responded in an ad hoc fashion, addressing symptoms rather than the disease: the looming insolvency of the financial system. At first the markets cheered their responses, but each intervention, more extraordinary than the last, brought diminishing market returns as investors realized the problems were only getting worse….Then officials let Lehman Brothers fall, wildly underestimating the collateral damage. They staved off an AIG bankruptcy, but miscalculated the cost. They did a poor job of selling their first major effort to apply a broader brush to the problem….A year in, policy is finally moving in the right direction, toward direct capital injections into banks and other efforts that strike closer to the root of the crisis. But the global economy has suffered a great deal of damage in the meantime….Now, despite the most extraordinary policy action to date, the stock market has collapsed and the credit markets remain tight. Some of that has to do with forced selling by hedge funds and other investors trying to stanch losses. But some of it arises from doubts that policy makers have their hands around the problems. They may get it yet, but their job will have been made much harder, by sowing uncertainty and pushing businesses, investors and consumers toward a bunker mentality" (WSJ, 10/13/08, pg. C1, by Mark Gongloff).

More recently, in his 10/26/08 article in the NY Times (Business section, pg. 7), the economist Ben Stein writes about why he was "unable to spot the stock market crash in advance, sell short and become rich." And in answering this question, he strikes many of the same themes as the previous two articles. "I don't have any magical powers to foresee the future. I did not foresee the catastrophic mistake, as I view it, by Treasury Secretary Paulson to allow Lehman brothers to fail. That failure left a gaping hole in the financial services industry, and blew away confidence that the Feds knew what they were doing."

Stein's article cites Anna Schwartz, who co-authored books with the University of Chicago economist Milton Friedman, as stating that "American banks did not face a liquidity crisis, but they might face a solvency crisis, that is banks have ample reserves to lend but might lack assurances that they could meet all their financial obligations if those loans went bad." The Ben Stein article agrees with her analysis, stating that "bankers have had so many losses and faced so much uncertainty that they dare not lend, for fear of killing their banks with bad loans, so we have actually had a solvency crisis….The solvency crisis exploded when Mr Paulson allowed Lehman Brothers to die a sudden death….After Lehman, I thought the government would issue blanket solvency guarantees to banks, but that did not happen, the stock market fell apart, credit went icy cold, and the wheels started to come off the economy. This also took me by surprise."

<u>Observations on the Future</u>

In discussing what the future might hold, we are led to the following observation: "There are always a lot of people raising issues, and half the time they are wrong. The question is what do you do" (Alan Greenspan, former Federal Reserve Board Chairman, testifying before Congress on his role in the current financial crisis, from the WSJ, 10/24/08, front page). While we think Greenspan was very wrong in his belief that private financial institutions could, at least collectively, manage risk appropriately with overly complex and highly leveraged securities, we also think he has made an extremely important point in this brief quote: With so much opinion, much of it conflicting, and much of it wrong in hindsight, the decision-makers must actually make decisions, always with imperfect information, and an inability, as Greenspan said, "to see events that far in advance." This makes any effort to discuss the future highly questionable. But since the future is the key issue, some effort in this regard seems called for.

First, we are going to present some of our own observations about the crisis we are living through, based on the substantial reading we have done on the subject. We then conclude with Professor Malkiel's article in favor of retaining and even adding to stock holdings.

1) Governments are the only source of large enough amounts of money to provide the opportunity for solutions to the current problems.

2) The US government is now, and likely will be in the future, focusing on three main areas:

   a) Providing new capital to financial institutions, with the main objective of making them more willing to provide loans to other financial institutions, businesses, and consumers. Also, capital may be used to purchase certain of the debt securities that have lost much of their value, which has impaired the capital and lending capability of financial institutions.

   b) Providing mortgage payment relief to what are now millions of homeowners whose homes are worth less than their mortgages. One of the main reasons there has been a significant time delay to these efforts is the question of who benefits; if limited to people in or near default, does such a plan encourage them to stop making payments?

c) A job stimulus program focused on infrastructure and other public works jobs. As unemployment increases, this effort is likely to take on major importance. Income from jobs is obviously crucial to people's ability to pay their mortgages and credit card debts, and to resume a reasonable level of future spending. It is also worth noting that even with all the negative employment news, including the loss of 1.2 million jobs during 2008, the US economy provides employment for 137 million people (NY Times, 11/8/08, front page and A20).

3) In discussing these programs, the scale is constantly questioned. For instance, the $700 billion rescue program has been criticized by some as too large. But the annual US Gross Domestic Product is projected at $14 trillion for 2008 (see NY Times, Sunday Business Section, 9/28/08, pg. 4), which makes the one-time rescue program figure 5% of one year's GDP. Our question is why a 5% figure is considered high. We would suggest it is a low number if it works, particularly since many of the transactions involved in the program are designed to provide an investment return to the government.

a) In a similar vein, the US stock market at its October 2007 high was valued at approximately $19 trillion (see WSJ, front page lead article, 10/11-12/08). Since international stock values had reached similar levels, total stock valuations amounted to $38 trillion. Add in all the investment debt securities and real estate values from around the world, and the asset value figure would likely have surpassed $100 trillion. Even with the past year's declines, how much money should the world's governments be willing to commit in order to preserve this reduced, although still huge, asset valuation, and attempt to raise it back up to the higher level? We have not seen this particular issue discussed, but certainly think it is worth considering.

b) A WSJ article (10/8/08, pg. A3), not prominently presented, cited an International Monetary Fund (IMF) projection of bad US assets generating $1.4 trillion of losses. The article cites the IMF saying that "threats to systemic stability became manifest last month, with the failure or near collapse of US institutions", and reports that "write-downs of US assets totaled $760 billion through September, suggesting the period of financial pain is only around the halfway point," even before taking non-US losses into account. "The private sector is unlikely to be able to address the problems alone, and piecemeal interventions haven't eased market jitters, so the IMF welcomed broader efforts to tackle the root causes. Such a comprehensive approach, if well coordinated among countries, should be sufficient to restore confidence and the proper functioning of markets and avert a more protracted downturn in the global economy." Here again, putting these obviously huge loss numbers into the larger context of a $100 trillion asset base, it is interesting to note that losses of 2%, or 3%, or 4% of the asset base have caused such dramatic negative consequences. Further, the asset base that may once have been valued at $100 trillion has obviously been reduced by tens of trillions of dollars at this point, based on declining market prices of so many of these assets. There appears to be a significant negative feedback loop at work here, and we look forward to finding information on, and reporting on, these subjects in the future, to better understand what has occurred, and is likely to occur going forward.

4) All the money that governments are likely to make available should generate additional inflationary pressures, since one of the main objectives of the programs is to increase the prices of various assets, ranging from housing and stock prices to distressed debt tied to mortgages, credit card debt, and debt incurred buying businesses in better times. While recessions typically result in lower inflation for some period of time, as businesses reduce prices in an effort to stimulate sales, the likelihood of large capital infusions from governments to combat the size and duration of the recession sets the stage for renewed inflation at some point in the future. Indeed, the remarkable (to us) decline in the recent price of US Treasury Inflation Protected bonds (discussed on pg. 7) may in part be attributable to the short-term outlook for low inflation. We think higher inflation is a likely outcome of the anticipated massive government capital support, however. Of course, the actual levels of price declines, subsequent price increases, and the time over which these price changes occur, are key variables affecting market prices, which we have no views on at this time.

5) In communicating the problems, we find that the terminology used can have a significant impact on public perception and understanding. The legislation that was labeled a "bailout" would likely have been treated far more favorably if called a "program to help the economy." When this same legislation was cast as a benefit to Wall Street, it received a far less favorable reception than had it been cast as a benefit to the broader economy (characterized as "Main Street"). Secretary of Treasury Paulson, with a Wall Street background as head of Goldman Sachs, was viewed by some as formulating programs to help Wall Street rather than Main Street. Public opinion and confidence can be shaped by these kinds of distinctions.

   Another example is comparing the current conditions with the Great Depression of the 1930s. This comparison is presumably designed to attract attention and frighten people, even though current economic conditions, and the governmental responses to meet those conditions, are considerably different now as compared to then.

6) Working from the premise that there are solutions to the current problems, history suggests that market price recoveries should follow. After a large price decline, using the 40% price decline of the S&P 500 from 1,500 in October 2007 to 900 now as an example, the percentage gains from the lower price levels can be substantial. A five-year recovery of S&P prices, from 900 back to 1,500, would involve average annual returns of approximately 10%. This level of return would be much harder to achieve starting from the higher base figure of 1500.

   a) This recovery is of course not a given, and we are not predicting it will happen. Rather, we are pointing out the kinds of returns that can be realized if the recovery programs work. Over the long term, stock prices are a function of corporate earnings, the level of growth of those earnings, and the price investors are willing to pay for a share of those earnings. Earlier this year, projected earnings for the S&P 500 companies ranged from $90 to $100 per share, so that a historically normalized price-to-earnings (P/E) ratio of 15 would have supported an S&P index valuation of 1,350 to 1,500.

Under current economic conditions, all earnings projections (the E part of P/E) become highly questionable, so trying to arrive at a fair price (the P part of P/E) for stocks has become extremely difficult. The return of ascertainable corporate earnings is therefore of major importance to a sustainable recovery in stock prices.

b) This idea of higher expected returns from assets that have experienced serious price declines applies across the board. For instance, the much beaten down junk bond investment, which a year ago had 7% and 8% yields but now has yields in the mid-teens based on current low prices, would have two significant sources of expected return, should the recovery occur. One would be from the very high income flow relative to current prices, and the other would be the price recovery itself, back to levels that at least approach the high levels reached during the previous strong market for junk bonds. Other income-oriented investments that have experienced substantial price declines, ranging from US Treasury inflation-protected bonds and high credit quality intermediate-term corporate bonds, to preferred stocks and commercial mortgages, all have the potential to generate high income yields as well as substantial price recoveries, all dependent on the hoped-for recovery. The downside to at least some of these investments is that possible defaults on bonds reduce the income flow, as well as the amount of the potential price recovery. As always, greater risk comes with the opportunity for larger gains.

7) This introduces our final observation, drawn from the Malkiel article previously referenced on pg. 8. The main point of the article is its advocacy of maintaining, and even increasing, stock positions. After discussing the current problems, Malkiel writes that "just because stock markets have panicked, investors should not. The best position for investors today is not fetal and 100% in cash. We are not going to have a depression, and we have survived financial crises before. A century of investing experience, as well as insights from the field of behavioral finance, suggest that investors who bail out of equities during times like these are almost always making the wrong decision. It is very tempting to try to time the market. We all have 20/20 hindsight. It is clear that selling stocks a year ago would have been an excellent strategy. But neither investors nor investment professionals can consistently time the market. The herd instinct is extraordinarily powerful….In bear markets nervous investors convince themselves that every light at the end of the tunnel is a train coming in the opposite direction. Panic is just as infectious as blind optimism….Look at history: the market eventually bounded back from the damaging stagflation of the 1970s and the savings and loan crisis of the early 1990s….Stocks also recovered from the Asian crisis of the late 1990. Similarly, investors who held on after the more than 20% one day stock market decline in 1987 were eventually well rewarded."

> "So what should investors do? ….Young investors, and those in their prime earnings years, should stay the course….Asset allocations should be shifted to safer securities over time as the investor ages, but only gradually and on a set schedule. If you are now approaching retirement and failed to move to a more conservative asset allocation, you should not do so now in response to a time of panic. If anything, well diversified investors should consider rebalancing to ensure that your portfolio composition remains consistent with the risk level appropriate for your financial circumstances and tolerance for risk. <u>But this is likely to mean</u> <u>shifting into equities and not out of them.</u> (our emphasis) Suppose you started the year with a portfolio of half stocks and half Treasury bonds, and that the value of bonds has gone up as the stock portfolio declined, so that the allocation is now 2/3 bonds and 1/3 stocks. <u>The appropriate strategy is to sell the safe bonds and buy more equities to bring the stock/bond ratio back to 50%</u>"(our emphasis again).

If Malkiel's article sounds familiar, it is because he, along with Vanguard's John Bogle, the author Peter Bernstein, and more recently David Swensen, Manager of Yale's endowment fund, have provided much of the authority on which we rely in the management of our clients' portfolios. We appreciate the fact that these experienced and well respected investment professionals provide material readily available to a highly interested public.

Victor Levinson **Nicholas Levinson**