For Clients and Friends of Financial Connections

Quarterly Newsletter, 2nd Quarter 2008, 7/21/2008

CORTE MADERA OFFICE

Our lease was up on the San Rafael office. We now have a location in Corte Madera (for those who know the area, it's by Book Passage). We've moved our computers to Marin.

Kim is usually in Marin. Brian and Jill split their time. We are available to meet in either location. If you'd like to see our new offices and go to lunch, just let us know!

Collectively, we save three hours of commute time when we work out of the Marin office.

We usually design our newsletters to discuss the economy and the financial markets along with other financial planning topics of relevance to our clients.

With all the sensational headlines and our entry into bear market territory (a loss of 20% from the previous market high), we will devote most of this issue to a discussion of the economy and financial markets.

"The first half of 2008 dramatically reinforced the idea that over the short term the stock market is predictably unpredictable." (AdvisorIntelligence June 2008)

The first quarter was down and then April and May surprised us by rising. But the June S&P 500 was down 8.6%, resulting in a total decline for the first half 2008 of almost 12%.

<u>Is this time different?</u>

Whether you originally became a client in 1987 with Gladstone Managed Investments or after Mel retired and started with Financial Connections, we've all been through a number of crises resulting in temporary stock market declines.

Each of these events offered their own challenges but they also held in common:

- Escalating bad news
- Increasing risk
- Accelerating fear and panic

While the causes of the market decline are different, the result is the same. We'll review the current problems.

continued inside...

GATEWAY AND LEUTHOLD FUNDS

Some mutual funds offer institutional shares. Since the ongoing expense of mutual funds is lower, they have an advantage. There is also a one-time charge (usually $24) to buy institutional shares.

In order to qualify, we aggregate our clients' individual positions to meet the minimum requirement to own institutional shares.

We will be making a tax-free swap for your regular shares to institutional shares for the above two funds. You will receive a notification (electronically or via mail) when we sell the current fund and then purchase the institutional share.

If you have any questions, please give us a call.

For Clients and Friends ...
(continued from front page)

Credit Crunch

In our last newsletter, we discussed the Fed's bailout of Bear Stearns. The financial community hoped this would improve the marketplace but it only reduced risk and fear temporarily. If you would like additional information, we refer you to a commentary on the cause of Bear Stearns' decline by Martin Whitman, Third Avenue Value Letters to Our Shareholders, April 30, 2008, pages 3-4.

We are in a circular pattern:

1. Mortgage payers fall behind.
2. As mortgages fail, banks must write off the loans.
3. Bad loans increase.
4. Home prices decline.
5. Financial companies can't or won't extend money—Some times they don't have the money to lend; other times they don't know how to price the property.
6. New home purchases can't get funding.
7. Businesses can't get funding for expansion.

Inflation

Oil prices increased to new all-time highs, supporting worries of increased inflation. With inflation worries, bond prices fall.

Food prices continue to rise. According to the Cattlemen's Network, from May 2007 to May 2008 the price of:

- milk increased 15%,
- eggs (one dozen) jumped 28%, and
- celery increased 106%!

Food usually accounts for about 13% of household spending compared to about 4% for gas.

Housing Market

While news articles feature foreclosures and the decline of home prices, they seem to have overlooked some good news.

According to a speech made by Treasury Secretary Henry Paulson:

- Inventories of new single-family homes are down 21% from their 2006 peak.
- Existing home sales appear to have flattened over the past several months, indicating that demand may be stabilizing.

continued on next page...

Jill D. Hollander, CFP®, CRPC®, Financial Advisor
Brian Pon, EA, CFP®, Financial Advisor

Financial Connections Group, Inc.
2608 Ninth Street, Suite 302
Berkeley, CA 94710
510.849.4667

Corte Madera office:
21 Tamal Vista Blvd., #105
Corte Madera, CA 94925
415.924.1091

EMAIL: client@FinancialConnections.com
WEBSITE: http://www.FinancialConnections.com

For Clients and Friends ...
(continued from inside, page 2)

Here is other good news:

- June home prices actually rose in eight of twenty markets covered by the S&P/Case Schiller Index.
- Monthly home price declines have slowed or reversed direction in most markets.

According to Tom Brown of Bankstocks.com, there has been a decline in the rate of new mortgage delinquencies.

Economic Growth

Growth in national wealth (homes, stocks, bonds, real estate, etc.) usually mirrors growth in the economy. Historically, our economy grows on average of 5.5%. But between 1981 and 2006, the national wealth grew at over 7%.

A fundamental truth in economics is that over long periods, extremes revert to the average.

After such a period of outsized growth, we should expect wealth to underperform to get back to the 5.5%. This reduction in wealth will mean slower growth for the economy and corporations.

Federal Reserve Activity

Over the past few decades a “shadow” financial system—mostly unregulated—has developed.

Some of us may remember getting our first mortgage from a bank or savings and loan. More recently, we would apply to a “mortgage company.” Same product, different institutions, regulated differently.

Already, the Fed is taking action that says in essence, “If it walks like a duck and quacks like a duck—it needs to be treated like a duck.” That is why you are seeing Congress and the Fed develop reforms to bring similar financial institutions under the same roof with the same regulation. We view this as a positive move.

Stock Market Valuations

The historical average price to earnings (P/E) ratio for the stock market is 16. Today the S&P 500 trades around 23 times its P/E. Using this measurement, the stock market is still expensive.

The positive news is that some of our mutual fund managers believe they are finding good buys for individual companies.

Return Expectations

History repeats itself but rarely in the same pattern. After an above-average decade (the 1990s) and a below-average period (this decade so far), it would be nice to anticipate an above-average period. But the market doesn’t care what we want.

The consensus in the financial community is single-digit equity returns, on average, over the next several years.

continued on back page...

MONEY IN BANKS

The FDIC insures bank accounts up to $100,000 per account title. The NCUA fulfills a similar role for credit unions. If you maintain account balances that exceed insurance limits, we recommend that you consider moving uninsured funds or consulting with your teller on how to structure your accounts in light of insurance limits.

You can also consider using money market mutual funds. Money market funds are not insured, but they are backed by the underlying value of short-term high-quality investments as opposed to the fortunes of an individual financial institution.

Most individuals should not maintain bank balances that meet or exceed these limits. Please let us know if you would like to discuss this topic or have any questions about it.

For Clients and Friends ...
(continued from inside, page 3)

<u>Consumer Confidence</u>

Consumer confidence is at a thirty-year low. Comparisons are even being made to the Great Depression. Is this realistic? We don't think so, based on the information below.

The most recent severe recession was 1982-83. The jobless rate was 7.5% and inflation was 14.4%. Today we're at 5.5% unemployment and 4.2% inflation.

Have the real estate markets dropped before? Yes, in 1991.

Is our view of the government contributing to our lack of confidence? We think so. The president's approval rating is below 25% and Congress' ratings are even lower.

<u>Summary</u>

- How long was the last bear market at the beginning of the decade? 31 months (March 25, 2000 to October 9, 2002).
- How long have we been in this bear market? 9 months.
- Will there be more surprises? Probably.
- Will we have a stronger financial system when we turn the corner? We believe so.

The market may get worse before it gets better. We continue to stick to the discipline that has been successful for us—to build diversified portfolios to weather the volatility in the market.

<u>Your reports</u>

While it is always difficult to see losses in absolute terms, please look at the percentage of loss vs. the various indexes. Because we take the long view, we report on returns for longer time periods.

For clients in the distribution phase, we continue to set aside money for upcoming disbursements. Yet participation in the equity markets provides the growth to stay ahead of inflation. The price of this growth is periodic declines.

Please let us know if you would like to discuss your specific situation.

Jill D. Hollander Brian Pon

FREDDIE MAC AND FANNIE MAE

These quasi-government agencies, formed in 1970, buy approximately 50% of the country's mortgages. Held in an investment portfolio, mortgages are packaged and resold as Mortgage-Backed Securities (MBS) to investors.

Accounting problems identified in 2004 resulted in changes limiting the quantity of mortgages they could buy. Other competitors in this area are investment banks.

As the housing market declined, both companies reported losses. But the credit crunch hurt investment banks more, increasing Freddie and Frannie's role in the mortgage market.

In February, federal regulators announced an easing of lending restrictions, attempting to add stability to the mortgage market. The Catch 22 of quasi-government agencies is they also act as private corporations. The stock prices of both companies fell dramatically.

The Federal Reserve is offering a short-term lending program to Fannie and Freddie hoping to keep mortgages available. Other overhauls are being discussed but not yet adopted.

How did this happen?

I'm sure this topic will eventually be a book. This problem started years ago.

Fannie and Freddie are not subject to the same financial standards and taxes as private companies. There is an implicit government guarantee; any losses would be paid by the taxpayers. While they pay federal tax, they are exempt from state and local taxes. They are exempt from the same capital requirements of banks and borrow money at lower than market rates.

Fannie and Freddie have a massive lobbying effort (involving both Republicans and Democrats) that tries to stop any additional regulation or oversight. They have been successful. As Fannie and Freddie became larger, Wall Street grew with them, purchasing the Mortgage-Backed Securities.

The stock price of these two companies increased 500% from 1990-2000; millions of dollars were paid to executives, and criticism was ignored.

Fannie and Freddie were not major players in the subprime mortgage decline but their loans were packaged with subprime loans and sold by Wall Street. The increasing foreclosure rate, late payments, mortgage value declines, and home price declines contributed to the mess we have today.

These two companies fall under the heading of "too big to fail," at least for now. Their stock prices are down over 70% in 2008.