Quarterly Newsletter,
3rd Quarter 2008,
10/14/2008

For Clients and Friends of Financial Connections

IN MEMORIUM

Melvin A. Gladstone

September 26, 1919–October 4, 2008

Mel's firm, Gladstone Managed Investments (GMI), preceded Financial Connections. Many of us started with GMI.

On Friday, October 3, Mel had a stroke and died the following day. A quick death, as Mel desired, but it caught the rest of us by surprise.

Mel was interested in everything and eager to learn more. He once told me Shakespeare was a feminist and proceeded to quote the passages proving it. Mel was equally enthusiastic discussing the Oakland A's or the latest event at Cal Shakes or quoting Gilbert & Sullivan.

I first met Mel in 1976 at Dymo Industries. Our lives crossed often from then on and in January 1993 I joined Mel's firm. He retired December 31, 1999. Always sharing, he started teaching at Kaiser about chronic illness and, most recently, had planned to tutor people who hoped to improve their English.

His loss leaves an irreparable hole in many of our lives.

Mel did not want any ceremonies but his wife, Edith, is planning a memorial gathering on November 16 at the Berkeley Faculty Club, from 3 to 5. If you want directions, please let me know. *Jill*

WHERE ARE WE NOW? WHERE DO WE GO FROM HERE?

Enclosed are your reports through September 30, 2008. Losing less than the markets doesn't mitigate the pain: paper gains are nicer than paper losses.

> "History Does Not Repeat Itself Exactly—But Behavior Does" (Robert Farrell)
>
> We have included two inserts in our newsletter:
>
> 1. A brief history of recent financial crisis and resolutions
> 2. A graph showing the stock market recovery after a financial crisis

We do not know how much more the markets will fall or how high they will bounce when the problems are resolved. If we lose less on the decline, we have a good chance of doing well on the rebound.

We are always available by phone or in person to discuss your situation.

<u>What are we doing?</u>

While analysts have said for some time that markets were overdue for a decline, no one was prepared for the magnitude or the rapidity of the changes. (See Current Situation article on world economies and corporate earnings.)

DIVERSIFIED PORTFOLIO DESIGN

- We are reallocating some of the equity portions of the portfolio to bond mutual funds and funds with low correlation to the market.
- We are harvesting tax losses to offset future gains. A tax loss is not synonymous with an investment loss. Below is an example:
  - Original purchase: $20,000 on 12/16/2003
  - Reinvested dividends (on which taxes were paid) <u>$20,233</u>
  - Tax basis: $40,233 on 9/30/2008
  - Current value: <u>$33,145</u> on 9/30/2008
    - * Tax loss $ 7,088 (40,233 minus 33,145)
    - * Investment gain $13,145 (33,145 minus 20,000)

<u>What can you do?</u>

WITHDRAW LESS

When markets decline, it is prudent to reduce withdrawals. The more money left in the account, the more potential to participate when the markets go up. If your withdrawal rate is too high because of the account's lower value, the risk of running out of money in the future increases.

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WHERE ARE WE NOW? WHERE DO WE GO FROM HERE?
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REDUCE SPENDING

It may seem obvious but—the less you spend, the more you can save. If you are close to retirement or just retired, it is imperative to preserve as much capital as possible to participate when the market rebounds.

OPPORTUNITY: CONVERT TRADITIONAL IRA TO ROTH IRA

With the decline in your IRA account, it might make sense to convert some of your account to a Roth IRA. You will pay the taxes on the conversion, but when the markets rise and you ultimately withdraw, no taxes are due.

OPPORTUNITY: CONTRIBUTE EARLY TO YOUR RETIREMENT PLAN

We've had several calls from clients wondering if they could make their 2008 contribution now—"buy now, when it is cheap"—instead of waiting until tax time next year. The answer is yes you can, as long as you don't contribute more than will be permitted once you prepare your 2008 tax return.

WE RECOMMEND YOU LISTEN

to an interview by Charlie Rose of Warren Buffet. You can see the video replay at: http://www.charlierose.com/shows/2008/10/01/1/an-exclusive-conversation-with-warren-buffett OR if you'd prefer to read the transcript, go to: http://everythingwarrenbuffett.blogspot.com/2008/10/charlie-rose-interview-with-warren.html

We think Buffet offers useful perspective on the current crisis and some historical perspective.

RECENT ECONOMIC ISSUES

Economic Stabilization (not a $700 Billion Bailout)

Future academic books will comment on how poorly this legislation was presented to the public. This will be a lesson on "What Not to Do."

The issue was not bailing companies out, but getting the economy kick-started. In an interview with CNBC, Warren Buffet declared the following in support of the legislation:

They [the government] *can make money on this deal. I can tell you this. I would love to have $700 billion at Treasury rates to be able to buy fixed-income securities now that they're in distress. There's a lot of money to be made.*

The problems break down into two primary issues: Liquidity and Capital.

Liquidity

Below are two examples of how consumers as well as business use liquidity in their everyday activities.

You and Me

If you eat out and charge tonight's dinner, a credit card company loans you money until you pay your invoice. The credit card company needs a loan while waiting to collect that sum from you.

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After a 32-year engagement, Jill and Bonnie will be married on October 22.
We think enough time has passed that our relationship as a married couple will last!

RECENT ECONOMIC ISSUES (continued from inside)

Business to Business lending

In Jill's previous career as manager, Treasury Services, she was responsible for managing the company's cash flow. She would forecast when there was a cash surplus or deficit. Through an intermediary, she would either loan or borrow money for brief periods of a few days or weeks. This market has frozen as well. Companies are afraid to loan each other money.

It is a temporary problem—a crisis of confidence. Once the Fed and the Treasury get their program working, short-term credit should flow again.

Capital and Leverage

To review, if you make a 10% down payment on a house and have a thirty-year mortgage for the balance, your leverage is 9:1.

What we have seen is banks regulated with rules allowing the leverage ratio of approximately 12:1. Investment banks, regulated differently (or perhaps unregulated), had ratios of 30:1. The leverage in exotic and opaque instruments was so high that investment banks did not have enough capital to support the losses (even if the losses were temporary).

Currently, there are no more "investment banks."

- Bear Stearns was bought by JPMorgan
- JP Morgan is now a bank
- Lehman filed for bankruptcy
- Merrill Lynch was bought by Bank of America
- Morgan Stanley filed to become a bank
- Goldman Sachs filed to become a bank

AIG is primarily an insurance company, but one division specialized in selling protection against credit defaults for a fee. There were too many defaults and not enough money to cover the losses. As a result of the credit crunch, this division endangered the parent company. Its insurance subsidiaries are financially healthy but regulations prohibit them from moving money to the parent company. So the government is loaning AIG money. Interest on the loan is approximately 11% and the government receives 79.9% stake in the company. During this time AIG will be selling subsidiaries to resolve its capital problems.

WAYS TO DE-STRESS

- See a picture of Robert Pon laughing (Brian will be happy to e-mail it to you)
- Take a walk and enjoy nature
- Turn off the TV (especially CNBC, MSNBC, etc.)
- Watch a funny movie
- Read a good novel with a happy ending
- Do exercise and yoga
- Go to your 40th high school reunion and laugh at how you used to look (Jill's recent experience)
- Listen to music you enjoy
- Play with children
- Close your eyes, take three deep slow breaths—just don't do this while you are driving
- Rearrange your furniture
- Focus on what is good in your life

Recession

Common sense says we are in a recession. Jobs are disappearing and many people have difficulties meeting their debt payments.

But a universal truth in economics is that nothing stays the same. Interest rates decline, housing markets rebound, investments in economic goods and services increase.

Jill D. Hollander Brian Pon

LOOKING BACK AT PREVIOUS FINANCIAL CRISES

If you would like an empirical law of government behavior, it is in that a panic or threatened financial collapse, governments intervene—every government, every party, every country, every time. Alex J. Pollock, American Enterprise Institute

September 2001—Terrorist attack
- Government offers over $40 billion rescue package, plus interest rate cuts.
- It urges consumers to spend to get the economy running again.

March 2000—Dot.com crash
- Stock prices for companies without earnings increased.
- Interest rate declined.
- Federal Reserve pumps liquidity into the market.
- U.S. experiences mild recession.

September 1998—Long-Term Capital Management Bailout
- U.S. hedge fund advised by multiple Nobel prize-winning economists with quantitative computer models failed (major problem—leverage).
- Fed organizes a bailout by banks and investment banks.

August 1989—U.S. savings and loan crisis
- S&L motivated by deregulation or poor regulation increased lending in risky commercial mortgages.
- Half the 3,234 S&Ls closed (1986–1995).
- Congress created Resolution Trust Corporation (RTC)—an asset management company responsible for liquidating primarily real estate assets and loans of closed thrift institutions
- RTC office would close in 1995. Cost to taxpayers about $160 billion, in 1995 dollars.

October 1987—Stock market crash
- Largest one-day decline: 22.6% of the Dow Jones Industrial Average
- Potential causes: program trading, portfolio insurance (an early use of “risk reducing” derivatives), arbitrage, and investor psychology
- Government action: restricted trading
- Liquidity pumped into the system by the Fed and reduced interest rates

September 1929—Start of the Great Depression
- By 1933, 1,000 homeowners lost their homes each day; 2,500 banks failed.
- Government buys defaulted mortgages and refinances at lower terms.
- Agency closed in 1951 with 80% renegotiated loans repaid.

Pre-depression financial crisis survived:
- Great Panic of 1907
- Panics 1884 and 1890; 1873, 1857, 1837 and 1792