

## *For Clients and Friends of Financial Connections*

Enclosed are your reports as of December 31, 2007.  
Included are:

- *Portfolio Position Analysis*: Holdings as of 12/31/07.
- *Portfolio Performance Summary*: Net returns (after fees) for 2007 and (on page 2) for the last seven years or inception if you are a newer client.
- *Realized Gains/Losses*: Printed on yellow paper should be given to your tax preparer (unless we prepare your taxes). It reflects gains/losses from securities sold by Financial Connections.

A look at the returns over seven years offers a more realistic market cycle of returns and volatility. For five consecutive years, the stock market produced positive returns with low volatility (only small fluctuations up or down). That changed the latter half of 2007.

### Year-End Review

The year 2007 began benignly for both the economy and financial markets but ended steeply negative.

### *Economic Review*

The U.S. economic slowdown started in 2005 but increased considerably last year. Some of the contributing factors were:

- Meltdown of subprime mortgages (affecting people with lower credit scores—usually below 600)
- Housing contraction reducing employment and spending
- Large write-down of loans by financial institutions, hedge funds, etc.
- Credit crunch (less money available for loans)
- Increase in energy and commodity prices
- Reduction in consumer spending (see related article)
- Corporate earnings slowed but still grew except in financial sector
- Higher probability of recession
- U.S. exports increased to 12% of GDP (as of 9/30/07)

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### **Quarterly Newsletter, 4th Quarter 2007, 1/25/2008**

CONGRATULATIONS KIM!

This fall, Kim passed the exam to become a registered tax preparer. She also passed the test to become a junior financial planner. This certification is offered through the College of Financial Planning and is called a "Paraplanner."

Please join Brian and Jill as we congratulate Kim on furthering her knowledge to help Financial Connections' clients.

**ATTENTION DOMESTIC PARTNERS—You must file your 2007 California State Tax returns either as Married Filing Jointly or as Married Filing Separately.**

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

### *Financial Market Review*

Modest gains were seen in the stock market for 2007 although all equity indexes were down in the fourth quarter.

- With the dollar's decline, companies with foreign-based operations did well
- Large companies outperformed small companies
- International companies performed better than U.S. companies
- For the first time since the tech bubble burst, growth outperformed value companies
- Emerging market stocks and bonds continued to perform well
- Commodity funds had another good year
- International bonds did well as the dollar dropped

The 10-Year Treasury Bond Yield was 4.68% on January 2, 2007, and ended the year at 3.91%.

### 2008 Expectations

To repeat an old refrain, no one knows what the future holds but many sources anticipate a more negative economy and stock market this year than in the recent past.

- Many believe a recession has already begun (a recession is two quarters of negative economic growth)
- The Fed, the president, and Congress are all putting plans together to stimulate the economy to prevent or reduce a recession
- The dollar may stabilize this year and possibly increase against the euro
- Unemployment may rise
- Inflation may rise (especially given energy costs)
- Housing market will continue to decline
- Additional subprime mortgage problems will continue as loans reset
- There is concern about a prolonged credit crunch and continued losses from credit derivatives

### *Financial Connections Thoughts*

As we frequently state, the stock market does not go straight up. Yet it has done so for five years. In 2008, it may well not. At the time of this writing, the U.S. market has given back all of the gains from 2007 and then some.

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#### **FINANCIAL CONNECTIONS GROUP, INC.**

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## WHO IS GIVING MONEY TO CITIGROUP, MERRILL LYNCH, ETC.?

As a result of the losses they have sustained, a number of financial companies need additional capital. What is interesting is where the capital infusion is coming from.

Citigroup and Merrill are willing to sell shares of their business to investment funds of foreign governments (also known as Sovereign Wealth Funds, or SWF).

According to Nouriel Roubini in his update in *Global EconoMonitor*, "if you run a current account deficit (import more than you export, spend more than your income, save less than you invest), you need to borrow from the rest of the world to finance your excess spending."

In the past, foreigners financed our deficit primarily by buying debt (i.e., Treasury bonds). But why should they settle for a low interest rate return on a 30-year Treasury bond when ownership of U.S. real estate or other assets has a higher potential return on investment?

This line of reasoning led to the creation of sovereign wealth funds. In 2005, when the Chinese government tried to acquire Unocal, an oil company, there was outrage and congressional opposition. The Chinese government withdrew its offer for "political reasons" yet Chinese investors already owned 70% of the company!

In 2006, Dubai Ports World, a sovereign wealth fund of the United Arab Emirates, took over seven U.S. ports. The uproar created in the media and by politicians led to Dubai's selling the ports to a U.S. firm.

Now, there is barely a murmur when foreign governments buy U.S. assets. Why? The most frequent comment is the percentage is under 10% so it is considered an investment.

Others say the shift is inevitable as globalization proceeds. Some congressional members are calling for investigations of the impact of SWF. When countries with beliefs that differ greatly from this country's invest in U.S. institutions, the impact is yet to be determined.

### *Little Known Facts of Interest*

- 11 Number of years since home prices fell
- 17 Percentage of workers whose retirement benefits have been reduced
- 27 Months—the average stay in an assisted living facility
- 39 Percentage of Americans who keep close track of their expenses
- 52 Percentage of 60-65 year olds still working in 2006 vs. almost 46% in 1996
- 77 Percentage of S&P companies paying out dividends in 2007 vs. 94% in 1980
- 90 Number of designations, degrees, titles, certifications, and accreditations available in the financial service industry. Is it any wonder consumers get confused?!

## CONSUMER SPENDING - THE ECONOMIC DRIVER

In our opening article, we mentioned a decline in consumer spending. Since over 70% of economic growth is dependent on consumer spending, it is clear why Congress, the president, and the Fed are looking for ways to stimulate the economy-to get consumers to spend again.

According to John Mauldin, an author and financial expert, "In 1992, consumer spending was a little over 65% of GDP. It is now closer to 72%. Savings are down from 8% in that time, to barely above zero."

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## ***For Clients and Friends ... (continued from inside)***

It is easy to focus on the negatives. But here are positives:

- While the unemployment number is increasing, it is still historically low
- Global liquidity remains strong
- Excess money from foreign governments (aka sovereign wealth funds) have invested capital in the U.S. (see related article)
- Except in the financial sector, corporate earnings are still growing
- Declining markets offer buying opportunities for some of our managers.

The Merger Fund in its October 10, 2007, letter to shareholders had a great line about the stock market. Investors “vacillated between extreme optimism and throw-in-the-towel pessimism.” In the short term the market reacts emotionally. In the long term, fundamentals, valuations, and returns still determine results.

Please come into see us to discuss your finances and investments.

## ***CONSUMER SPENDING – THE ECONOMIC DRIVER (continued from inside)***

This is somewhat of a catch-22. When consumers spend more, much of it is on products made in foreign companies. It increases the trade deficit. This increase requires someone (usually foreign countries and investors) to finance our debt.

## **GREEN INVESTING**

Vehicles to invest in “green energy” are becoming more numerous. Several exchange-traded funds (ETFs) hold a basket of stocks that follow a specific index. We don’t necessarily recommend these ETFs. Not enough time has elapsed to develop risk/return data.

PowerShares WilderHill Clean Energy Portfolio - holds 40 primarily small company stocks that produce green or renewable energy or related technologies

PowerShares WilderHill Progressive Energy Portfolio - differs from the one above because it targets companies that improve the technologies of existing fossil fuels

PowerShares Cleantech Portfolio - invest in knowledge-based companies that try to reduce costs, inputs, energy consumption, waste, or pollution

First Trust NASDAQ Clean Edge ETF - investing in renewable power generation, renewable fuel, energy storage and conversion, energy intelligence and advanced energy-related materials

Claymore/LGA Green - targets alternative energy but buys stock in large companies such as Mobil and GE that allocate a portion of their research dollars to green technologies

Van Eck Global Alternative Energy ETF - 30 publicly traded stocks that obtain at least half their revenue from alternative energy activity. It is global in nature and weighted toward large companies

If this type of investment is of interest to you, please contact us.