

October 16, 2008

Dear Valued Investor:

On Tuesday and Wednesday we gave up much of the ground we gained on the Monday rally in U.S. equity markets. Then today, after being up and down, U.S. equity markets closed higher, with the Dow up 401 points. This high volatility reflects a whole host of concerns. Markets are worried about whether the government rescue plan will work, how deep the recession will be, a continued “freeze” in interbank lending, arcane but very serious issues involving “credit default swaps”, concerns that hedge funds may blow up, and on and on. On the other hand, I think many stocks are looking cheap, attracting buyers. I expect markets will remain volatile for some time. I hope we have seen the low but, of course, have no way to know.

Listening to various government officials, I think the message is that they intend to do whatever is needed to stop this financial market crisis and restore confidence. Federal Reserve (Fed) chairman Bernanke made that pretty clear in his speech yesterday. He also spoke very directly to fears of a return to the Great Depression. He noted that back then the Fed seriously aggravated the downturn by allowing a wave of bank failures and allowing a collapse in bank lending and the money supply. Nothing was done to help otherwise healthy banks to meet runs on them by depositors withdrawing their cash. Bernanke pointed out that the Fed’s lack of support went on for three and one half years before positive steps were taken. As he noted and I agree, that is definitely not the case today. The Fed has moved promptly to flood the system with liquidity. They have increased bank reserves by \$132 billion in the last four weeks and increased total reserves supplied by \$606 billion. Based on their announced intentions, I expect they will increase bank reserves by more than \$1 trillion over the weeks ahead. I am seeing monetary policy that avoids the mistakes of Great Depression monetary policy and shows that we learned from those mistakes in a very big way.

Meanwhile the Treasury has taken \$125 billion in preferred equity stakes in the nine largest U.S. banks and will take another \$125 billion in stakes in other banks to shore up bank capital and restore confidence. The FDIC is now temporarily guaranteeing all FDIC-insured institutions’ senior debt and will provide insurance coverage for all non-bearing-deposit transaction accounts. They are also working to get the Troubled Asset Relief Program (the TARP) up and running to lift bad assets off bank balance sheets. The problem is that this program and some other actions take time to get started, and the market does not want to wait. I think they could move faster on some things. For example, I do not understand why the Fed is dilly-dallying on the announced program to become a big backstop buyer of commercial paper. Heck, they already have a one page term sheet, and the Treasury has supplied the money—so why wait around until the scheduled start date of October 27?

As I have noted before, the enormous stress on global financial markets has exposed some very serious flaws and failures of the system. Troubled mortgages have now taken a back seat to other failures. One huge new problem involves the “Credit Default Swaps” (CDS) market. This market imploded after the failures of Lehman and then AIG in mid-September, which were, in my opinion, the events that triggered the latest plunge in stock and bond markets and forced governments around the world to shift to direct equity injections into many banks to stop this huge new problem. Given how swift and powerful the CDS meltdown was, I want to explain what I think happened. The CDS market is an “over the counter” market for trading insurance on defaults on bonds and all sorts of other stuff. “Over the counter” means there is no open, transparent, regulated exchange process. Some analysts have compared a CDS to home insurance, which is not accurate. Here is my best analogy. Suppose somebody wants to bet that you are going to default on your mortgage and somebody else wants to bet that you will not. Well they could enter into a CDS with one side betting on your defaulting and the other betting that you will not. Since the swap is done “over the counter” you would not even know that folks were betting on whether or not you would continue paying your mortgage. Also, a whole bunch of other people could make the same swap agreement on your mortgage. You wouldn’t know and nobody else would know how many people had entered into a default swap agreement on your mortgage. You could have millions betting for and against your potential to default on your mortgage. I know this example sounds completely crazy, but it is a simplified, but I think accurate, characterization of the CDS market place.

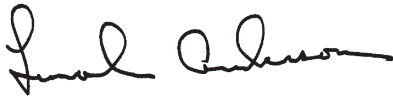
When Lehman failed due to a host of factors, folks found out that CDS insurance agreements Lehman had made were now part of the bankruptcy process and possibly worthless, while those who were insuring (betting) against defaults on Lehman debt had to pay up. And, while nobody knows for sure, it appears that the CDS swaps on Lehman’s debt totaled more than four times the face value of that debt! And when AIG failed the next day, it was largely due to the company’s CDS exposure insuring (betting) against mortgage securities defaults. These realizations caused an immediate meltdown in the CDS marketplace, estimated at \$50–60 trillion globally (again, nobody knows for sure) and an immediate rise in global default risk all over the place in securities markets. Interbank lending halted because nobody knew how much CDS risk banks really had, forcing governments into taking direct ownership stakes—it wasn’t just a “troubled mortgage asset” problem any more. It is now pretty obvious that the CDS structure is a totally shattered part of the financial system that has caused great damage to financial markets and the economy and, I think, will have to be completely overhauled, converted to an open exchange process and heavily regulated. Another really bad movie plot.

Where do we stand? Well equity and credit markets around the globe remain highly unstable. Securities that are viewed to be at all risky have had their prices fall to what I consider fire sale levels, while very low risk

securities like Treasury debt are very expensive with low yields. Risk avoidance is very high. I do think that governments and central banks around the globe are now fully committed to resolving this financial crisis and stopping the carnage. I think they will succeed. And when we come out the other side, I expect we will rebuild a much stronger and safer financial system. My regrets at not seeing this financial market meltdown coming are many, and I wish I had a “do-over” but that is not how the world works. I do take some small comfort from the fact that while we have to endure the consequences of all this stupidity and cupidity on Wall Street, at least we did not contribute to it. We will hit bottom somewhere; I hope it is near and soon or possibly behind us. I continue to believe that selling now would be a mistake and that staying with a well diversified portfolio is the best course of action, but the next few months are likely to be very difficult for the economy and financial markets.

As always, but especially now, please call your financial advisor with any questions or concerns.

Sincerely,



Lincoln Anderson  
Managing Director, Chief Investment Officer

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There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

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