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Trusted Advisor

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Quarter End Review – March 31 2009

We are looking forward to reporting first quarter results to our clients, as we have significantly outperformed major stock indexes throughout the world. Put another way, out clients' account values have held up relatively well in one of the poorest financial environments in a century.

It has been a tough start to 2009. The new Obama administration, it was hoped, would offer fresh ideas for slaying the multi-headed financial dragon that has been attacking the wealth of Americans and citizens throughout the world. Despite the new President's confident demeanor, his choice for the key position of Treasury Secretary, Timothy Geithner, has been challenged to communicate effectively his plan to turn the economy around. Average Americans simply do not understand why things have gotten so bad and why they are being asked to commit generations of future Americans to debt so as to save the "suits" on Wall Street. To quell a rising chorus of Populist discontent, key players such as Fed. Chairman Ben Bernanke have tried to reach out to ordinary folks. Viewers were treated to an extraordinarily candid interview with Bernanke on CBS's *60 Minutes* on March 15, 2009. As it turns out, this brainiac and expert on the Great Depression, once waited tables at a Mexican restaurant, while wearing a sombrero. Gotta like a guy who's been in the trenches.

WHO WE ARE

Certified Financial Planner™ with 35 years direct experience advising investors

WHAT WE OFFER

Complete review of your budget, your tax situation, and your ability to build wealth. We can also review your safety net:
Sufficient emergency fund?
Properly insured?

WHY YOU CAN TRUST US

We are retained as direct consultants to you. Since we act as fiduciaries, we do not offer any products, insurance, or investments for sale.
We are your trusted advisor.

HOW WE ARE COMPENSATED

We are paid by you for rendering advice for your benefit. We may make a one time review or provide ongoing financial and investment advice. Our fees are very competitive and fully disclosed.

Certified Financial Planner™

Gary Miller is in his 35rd year of providing financial guidance to individuals and pension plans. He is a Registered Investment Advisor and a Certified Financial Planner ™ Practitioner. Gary holds a Certificate in Personal Financial Planning from the University of California, Irvine and has served as a Board member of the Financial Planning Association, Orange County Chapter.

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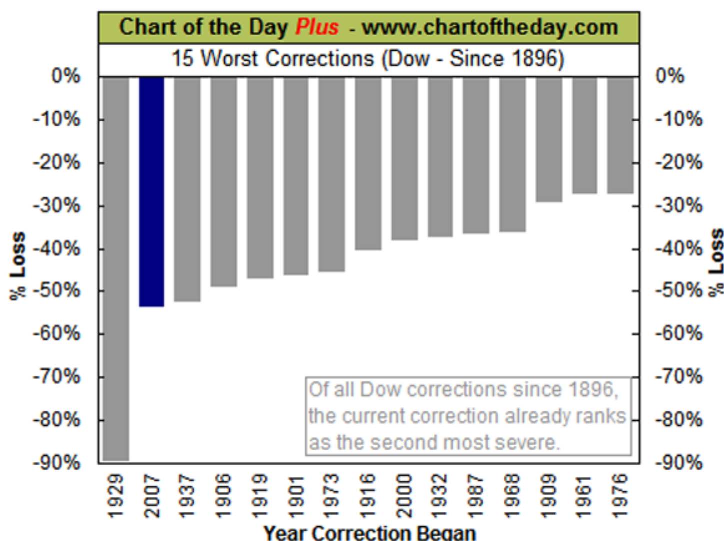
Members of Congress (MOC) have seized every available opportunity to express their MOC "outrage" at bonuses paid to salesmen and executives at companies who have taken Federal funds as a lifeline. Many oppose massive government spending and have expressed MOC shock at deficits of unprecedented levels. This has not, however, caused them to back off on loading recent legislation with earmarks. In an action that would be applauded by Hugo Chavez of Venezuela, Congress targeted AIG bonuses with special confiscatory tax rates. Even some Republicans voted for this populist pandering. Congressional heat has, sadly, drowned out cooler heads, generally people who don't have to run for office.[1] Despite these very worrisome developments the stock market has been staging a meaningful rally.

<u>In general, clients who have had accounts with *Trusted Financial* for five years or more, remain in positive territory.</u> Why is this the case? First, we do not employ leverage. Second, the companies in which we invest are screened to assure they have not borrowed excessively. Finally, we maintain strict diversification discipline, in good times and bad. Our clients are typically diversified into other non-equity investments such as bonds and cash.

The current bear market is the worst in a century (see graph), and yet our clients' retrenchment has been small enough to allow a fairly rapid recovery, once things turn around.



Only one bear market since 1900 has been worse, and that was the infamous 1929 crash. During that crash, equities values, on average, lost 90 percent. The chart above was prepared just before the Dow Jones Industrial Average reached a recent retrenchment of about 60 percent and it is highly possible we will fall to another, lower, low. Still, I would be very surprised to see a bear market of the magnitude of 1929. Why? Even if the economic situation were to move in a more negative direction, the real reason for the extreme sell off in 1929, beyond deteriorating fundamentals, was the fact that back then, people could buy stock with very little down and use high levels of borrowing ("margin"). If you only have 10 cents invested in a stock that is trading at $1.00 and that stock price falls to 85 cents, you've lost not only your original 10 cent investment but an additional 5 cents (50 percent). It was in this environment that people sold in a complete panic and lost everything 80 years ago. One of the reforms that grew out of the 1930's securities legislation was a requirement that a deposit of at least 50 percent be posted for any securities purchased. Therefore, the number of people who have seen their equity disappear in the current bear market is much lower then it was in 1929. This should avert a panic of that magnitude.

Housing Bust Parallels 1929 Crash

The current mortgage and real estate crash have a nearly identical origin as the Crash of '29: "Zero down" or 5 percent down home purchases have meant that "owners" have very little skin in the game. If their homes lost just 5 or 10 percent of value, these people were "underwater" and had little incentive to stay in the property and continue to make payments on their borrowing. It is difficult to comprehend why regulators continue to allow home purchases with so little down, until one grasps the role of politics. Legislators at both the state and Federal level are incessantly lobbied by industries that tend to benefit from a booming real estate market. Home ownership has nearly gained the status of an entitlement in this country. Liberal legislators have tried to make it

possible for the disadvantaged (minorities, poor) to own their own home. While noble, this is not an economically sensible goal. Conservative legislators are usually elected with a lot of help from pro-business groups such as the *National Association of Home Builders* and *National Association of Realtors*. Elected officials of all denominations receive generous support from the banking and brokerage industries. Together, Senators, Congressmen and Presidents have been cajoled into giving special tax allowances for homeownership[2]. Further, in the most recent housing boom, the normal corrective process of rising interest rates was distorted by our friendly Chinese and Japanese lenders, who artificially drove down long term interest rates in 2004, just as the Fed was trying to control the Boom. With low cost, specially structured mortgages, home values were inflated far beyond what would have otherwise been the case. As people came to believe the sky was the limit, they began borrowing out their home equity for expensive remodels, automobiles and trips abroad.

What we now experiencing in the residential market is simply a return to a more normal level of valuation. Prices in 2006 were bubble prices and I suspect will not be reached again for a generation. It would be nice if the government created a national regulatory body to oversee shenanigans in the real estate industry, as it did with the securities business in the 1930's. As with securities, lending should be strictly regulated, and the days of *"zero down" interest only loans* or *Option Adjustable Rate Mortgages* ended. If a family cannot afford to put 25% down on a home and pay a normal, fully amortizing mortgage, too bad. We cannot afford to risk our entire economy on houses occupied by overleveraged borrowers. Sadly, I have heard of no legislative proposal to end the irresponsible lending practices that got us into this mess, only proposals to bail out the offenders, while they are pressured to lend, lend, lend. Repeating the mistakes of the past may doom us to a repetition of the current debacle.

Bear Market Rally

Starting on March 9, a significant rally for equities worldwide commenced. This week I received my first email from a client wondering if it might be time to re-enter this "mosh pit" of a market. In my view, it is far too early to know if we have seen the bottom. The market has held up well for two weeks amid the AIG bonus furor and China's intimation that it wants to find an alternative to the US Dollar for parking its $Trillions. I suspect this rally has legs and will take many stocks higher still - back up to their 200 day moving average. This would make it only a normal Bear Market bounce. Beyond that, I would be surprised if we went any higher for a long time. There is plenty of bad news ahead: commercial real estate is the other shoe that is about to drop and pull down more financial institutions, in my view. Then there are the credit card backed collateralized bonds that are held all over the planet. These are toxic loans similar to collateralized mortgage obligations. I fear this fire is far from being extinguished. Also, having watched markets closely for 35 years, I know that a considerable amount of time and "base building" will be required before a sustained bull market can emerge.

Widely Held Stocks

Our focus of the past quarter has been twofold: reducing stock exposure based on objective analysis and increasing the quantity and quality of bond holdings.

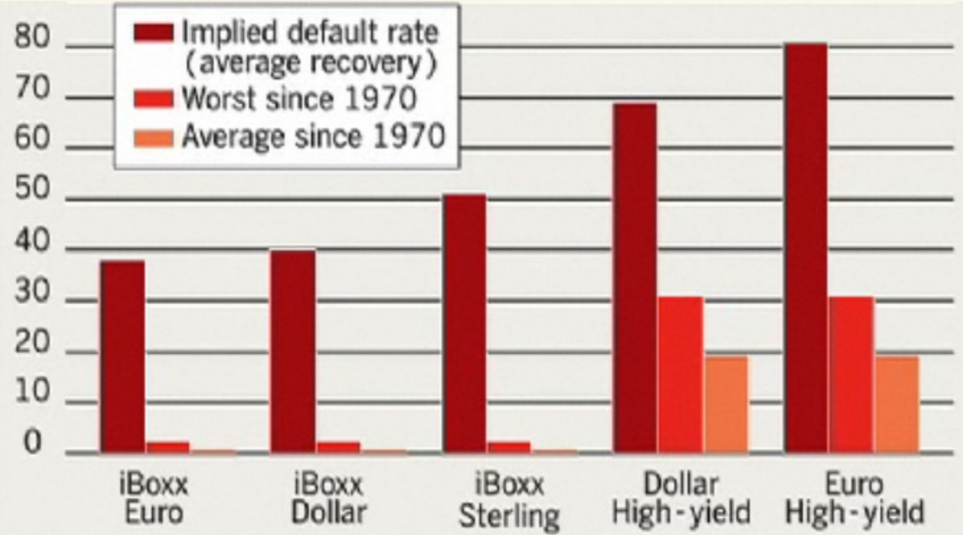
We continue to be bottom up stock pickers, and have added to a couple of select positions. There are good companies that are buyable, but I prefer further evidence of a trend change in the overall market before making large commitments to stocks.

Morningstar published an update last week of its "bear market buy list". I was intrigued and pleased to see that our stock holdings: PepsiCo, Proctor and Gamble, Colgate Palmolive, and IBM made the list with five stars and a high "*Certainty Rating*" in terms of valuation and upside potential.

Being of Service

We have been opening a significant number of new client relationships in the past few months, as other advisors have disappointed their clients.

I invite you to share this Newsletter with your friends, acquaintances, tax advisor or anyone else who might benefit, or who might want to explore a relationship with Trusted Financial Advisors.



Why we're excited about bonds:
The chart above was derived from research conducted by Deutsche Bank and quoted at *FT.com* on March 25, 2009. It shows that yields on investment grade and high yield bonds are being driven by an inordinately high fear of future defaults. The assumed or "implied" default rate for investment grade (BBB rated and higher) corporate bonds in dollars is 40%. This is, in my opinion, absurd. We have been buying bonds with ratings above BBB, and we research each purchase rather than simply accepting the given quality rating. Therefore, it is our belief that the default rate on our client purchases will be at the historic average or even below, yet we enjoy yields driven by a market distorted by widely held misperceptions of risk.

Sincerely,

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Footnotes:

1. According to the National Taxpayers Union website, www.ntu.org, "In the final analysis, Congressional pension benefits are 2-3 times more generous than what a similarly-salaried executive could expect to receive upon retiring from the private sector".

2. Beginning in 1997, the first $500,000 capital gain on sale of a "first home" was exempted from taxation. Such a break has never been extended to stocks, bonds, collectibles or any other form of capital investment.

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