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What Should You Do in Light of the Sub Prime and Residential Real Estate Woes?

It seems like every time there is a financial "crises", we get to learn about a new fan-dangled, gee wiz financial technique or some underlying mania or dysfunction that "surprises" many. Example:

- Following the one day crash in 1987 we learned about "computerized trading" and "portfolio insurance." That was truly a scary day, but for those of us who stayed the course, it too became just one more historical financial event.
- A few years later, we experienced the "Savings and Loan crises" (This was very serious. It came close to collapsing the U.S. and global financial system).
- In the summer of 1998, we heard about the "Asian, contagion" (The currencies in the Emerging Market countries collapsed and the U.S. stock market[1] fell by over 20% in one month).
- In the late 90's, we learned about "dot com's." This bubble precipitated one of the largest stock market crashes in one hundred years. Despite the crash, those with globally asset allocated portfolios, recovered in half the time of the U.S. stock market.
- The latest incident is the "subprime" mess.

Are there any lessons to be learned?

In our view the answer is yes. Our answer is eloquently simple. Our answer is boring. Further, you already KNOW our answer and are probably tired of hearing our answer(s).

1. **Stay cool, calm and collected.** Maintain a globally asset allocated portfolio that reflects your "risk tolerance" (Your "sleep-at-night factor") and your personal financial goals.

2. **Don't dust-off your crystal ball and be tempted to "time" the markets.** History has certainly demonstrated over and over that it does not work. Just contemplate the mad gyrations of this year's equity market.[2] Because if ever there was such a concentrated period of time which demonstrated so many different times, in so many different ways, the futility of trying to gain a consistent timing advantage over the market, we certainly don't remember.

   The market opened the year continuing the gains which characterized 2006's 15%-or-so total return. Then in February and March, it suddenly collapsed, falling something close to 8% within a couple of weeks. Then, with the media screaming of impending disaster, it turned on a dime.

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[1] Standard and Poor's 500
[2] Standard and Poor's 500

After a rally, and then another test of the March lows, the market shot-up: It ran from 1380 on the S&P 500 to 1540 – a gain of about 11% - in three months. Then it ran up further in mid July as the same journalists deliriously noted. The investing public went nuts, abandoning any remaining tortoise disciplines. Then the "Katrina" of the financial markets hit with the credit bubble.

The equity markets went into a melt down with about a 10% decline in three weeks, and the "chicken little" reporting was hysterical. As we write this update, the market has come virtually all the way back to the summer highs.

So, in ten months:

- Up, continued.
- Down, suddenly and spectacularly, to new highs.
- Down, with savage severity.
- Up, serenely back to the summer's highs.

The lesson, despite all of the energy spent understanding the economy in the hope of telling us what the market is going to do… it WON'T. Forecasting the market is a fool's game.

While goals-focused investing, in our judgment, lacks any merit whatsoever, we believe it guarantees failure in achieving your long-term goals.

3. Most importantly…and the most difficult lesson/advice is to **ignore the news!** Yes we know that is impossible. You must constantly interpret the news with the knowledge that separates you from the masses of investors in the markets. You know that investments in "equities" (Business and real estate, whether owned directly or through the stock market) are long-term holds. The markets, short-term, are "voting machines" and long-term are "weighing machines."

Let us ask you, would you prefer to believe the advice from academic, objective, Nobel Prize Laureate's and real world experiences, or the "Wall Street" "experts" who always seem to get into these messes? Thus, <u>if your portfolio matches your goals, time horizon and risk tolerance…STAY THE COURSE</u>."

What do we think?

Of course we have our views of the current economic and market conditions and what could possibly occur. However, <u>our experience and discipline remind us NOT to act on these views</u>. Probably one of the biggest jobs we assume as your trusted advisor is to help save you from getting caught-up in the emotions of the moment, to maintain the discipline and to remind you of the "big picture."

So here goes. The real estate bubble is a condition we warned you about in previous market commentary. Thus, no surprise here. In certain sectors of the country, residential real estate did turn into a mania. In others, it has softened. All markets experience mania's, bubbles and crashes. It is basic human nature. But, we still find it amazing that people have such short memories. The massive stock market crash of 2000 was just a few years ago, yet the residential real estate mania occurred nonetheless.

Many smart observers of the mortgage market expressed their concerns over lax lending policies. We certainly discussed them. Anyone with the slightest common sense knew that when you can borrow with nothing down, with loan terms that take a PhD. in mathematics to understand, combined with the "certainty" of unfettered rising real estate prices, trouble was brewing.

As with all mania's and corrections, excellent buying opportunities can arise. If you are looking to "scoop" up a sweet deal in residential real estate, we suggest you hold off for a while. With the exception of foreclosures, we would expect lower prices in the next year or two. There has not been enough pain yet to reset prices.

If you are selling your home, we would recommend you wait if possible. With the exception of the sub-prime real estate, most real estate markets remain soft, but not crashing.

Simple common sense and a perspective of history and human nature win again.

We find it amusing that once again, the "Wall Street geniuses" have out smarted themselves. They engineered such complicated products, even they do not know how to evaluate or price these exotic vehicles. But, this is not a new phenomenon. Part of the latest craze, besides sub-prime packaging by Wall Street, has been the public interest in hedge funds (reminds us of "portfolio insurance" in the late 80's). Once again, many of these expensive, "bullet-proof" hedge funds run by the Wall Street "experts," blew-up with their sub-prime bets.

Greed: an old lesson relearned

The Wall Street gurus are not the only players at fault in this credit bubble. The common thread is once again is human in nature…**GREED**. The mortgage brokers were rolling in the dough. Borrowers were blinded/ignorant and, evidently, many were dishonest. The credit rating agencies' assessments of the risk of securities based on sub-prime debt turned out to be even worse than useless. Of course, the large Wall Street and banking institutions could not help themselves, as they too were raking in the dough. Even the Federal Reserve board contributed to the sub-prime melt-down by creating excess liquidity and very cheap money.

How will this current "crises" end?

Our guess is there is more bad news in the residential real estate market and the credit markets. We expect more home foreclosures (primarily in the sub-prime sector); additional write-offs by the big banks and Wall Street firms; continued price declines in housing; decreases in employment growth (although still decent by historical standards); and definitely a slowing economy. (Note: We do not see a recession, although the odds have increased. At this time, we would put a recession at about 50%). Remember, a recession affects those who lose their jobs. It is only a temporary factor for long-term investors.

Is there any more bad news?

Yes. But then again, there are ALWAYS dark clouds. Even though "core" inflation (the government excludes energy and food prices because of their volatility) has remained low, it seems that oil and food prices are in a more permanent state of higher prices. But, near-term, the U.S. economy will slow, which should temper oil prices in the short-run.

What do we think about oil price?

First, we were wrong a few years ago. We felt that supply/demand dictated oil prices in the mid $50 per barrel range. We did write last year that we thought $70 dollar a barrel oil was healthy. One, because it is below the $80 per barrel rate which is where oil prices should be if adjusted for inflation. Two, oil was priced high enough to encourage increased production and conservation.

While oil at $80 per barrel is a fair price based upon inflation, we are very impressed with the resilience of the global economy to absorb such a large price increase in such a short time.

It seems now that the terrorism factor is a small part of the current price levels. Clearly there is a temporary supply shortage coupled with a significant increase in demand (particularly from China and India). Additionally, the weaker the dollar, the more expensive the oil.

We will not be surprised to see oil prices over $100 per barrel. We could even see $4 per gallon gasoline. However, due to slowing economic growth, we don't believe we will see these price levels.

In Summary?

While the headlines always seem so daunting, we've seen much worse. Our view is the recent news regarding the sub-prime loan collapse and softening of the residential real estate market are not surprises. There is always something to worry about. As long-term investors, these events become small blips.

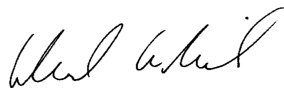
Our strong economy has surprised many for the last decade as it has withstood incredible economic and political shocks. As in the past, this too shall pass.

We do see a slowing economy, but no recession in 2008. We see slower job growth, residential home sales declining and interest rates unchanged from current levels. We can't tell you what the markets will do over the next six to twelve months. Give us a five to ten year horizon, and we are raging bulls.

What should be done? Refer to the lessons learned above.

Have a great 2008!

Best regards,



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