

Delta Financial Advisors

October 2008

Given the extraordinary economic and market conditions realized in recent weeks, we wanted to step out of our normal newsletter format. In these difficult financial markets, we wanted to share again our fervent belief in investing based upon appropriate asset allocation. By understanding a client's current financial situation, their goals and objectives and both their ability to assume and comfort in assuming risk, we aim to design a risk appropriate investment portfolio.

Asset allocation is the bedrock strategy of the portfolio in which the tactics lie in the selection of the individual securities placed into a given portfolio. Complicating the process is the fact that an investor's risk tolerance is continually changing. When financial markets are going up, people typically want to assume more risk as it increases their gains. However, when markets turn down, risk magnifies portfolio losses. It is in these times that investors often re-evaluate their risk tolerance as studies clearly show that losses "hurt" more than the "pleasure" generated from realizing investment gains.

We have had many recent phone calls from clients asking whether they should try to time the market and move all of their investments into cash. Unfortunately, the correct time to do so was a year ago and not today. If securities were to be sold now, portfolio losses would be permanently locked in.

While comforting, cash provides little or no upside once taxes and inflation are taken into consideration. Despite that, the comfort of

being in cash can still sound very appealing. The big challenge is that just as it is almost impossible to accurately time when to get out of the capital markets, it is equally difficult to accurately time when to get into them. By the time the markets look more stable and an investor might be ready to re-enter the markets, much of the markets' recovery is likely to already have occurred.

Academic studies show that the vast bulk of the markets' returns come in just 1 or 2 percent of trading days. If those days are missed, investment returns are only slightly higher than those of cash. Another market timing analysis focused on the ramifications to a long term investor which examined decades long periods similar to the investment horizon of most investors. The findings were shocking in that those investors who missed just a few of the market's best days had their long term returns cut by more than half!!

We are very cognizant of how difficult the current market conditions are, however, we continue to believe that long term investors will be rewarded by well considered actions and continued patience. In these difficult times, please do not hesitate to pick up the phone to call us and discuss any specific concerns or issues.

Economic Comments

Given the unprecedented market and economic activity of the last six weeks, we are going to step out of our norm and discuss matters through the date of this mailing. As this letter is being written, the U.S. credit crisis has become a global issue. While not officially announced, it is now a near certainty that the U.S. economy is in recession. More critically, the quickly

growing concern is that the global economy is increasingly likely to fall into recession.

The seeds for this real estate driven crisis were planted in Congress' demand to make housing more affordable for the poor. As a result, the country's primary mortgage enterprises, government backed Fannie Mae and Freddie Mac, sharply reduced loan qualifications and required down payments. The net result was the real estate bubble that peaked in 2005/2006.

Since then, the problem has been sharply worsened by accounting rules requiring financial institutions to value their mortgage securities based on current market values. As real estate values have declined, financial institutions were forced into a vicious cycle of continually lowering the value of their securities each time their competitors did so in a lethal death spiral.

In an effort to combat the increasingly frozen fixed income markets, the Federal Reserve on October 8th made an extraordinary, out of cycle, rate cut of ½ percentage point of its benchmark overnight lending rate to 1.5%. With inflation concerns sharply abating, the Federal Reserve focused its attention on stimulating economic growth. However, the Federal Reserve's actions went largely ignored by financial markets. Typically, major banks lend money to each other overnight for a modest risk premium of roughly 0.2 percentage points. This risk premium has increased by more than 20 fold in recent weeks as banks have become extremely wary about the financial viability of their peers.



Performance as of 10/09/08

	<u>Close</u>	<u>YTD</u>
<i>DJIA</i>	8579.19	-35.3%
<i>S & P 500</i>	909.92	-38.0%
<i>NASDAQ Comp.</i>	1645.12	-40.7%
	<u>Current</u>	<u>Prior</u>
	<u>Yield</u>	<u>Yr. end yld.</u>
<i>10 yr. U.S. Treasury</i>	3.83%	4.03%

The driving factor is that each bank knows the games it has played (or could have played) in valuing its now illiquid assets. As a result, each bank is now loath to believe in the quality of their peer’s assets – this suspicion has put a near freeze on the inter-bank lending market.

The U.S. government and Federal Reserve have taken a number of unprecedented actions in recent days to try to stem the continued panic. Congress has approved the \$850 billion Troubled Asset Relief Package (TARP) which includes \$700 billion for the U.S. Treasury to use in acquiring troubled assets from financial institutions. Contrary to popular opinion, this is not a \$700 billion bail out. Rather, this initiative involved the planned purchase of up to \$700 billion of currently illiquid securities. In fact, there is a greater likelihood of the Treasury realizing a profit on these securities than it realizing a loss.

In the absence of a functioning financial system, the Federal Reserve has announced plans to lend short term money to companies

that have been shut out of the commercial paper market. As a refresher, commercial paper is short term (less than 9 months) unsecured obligations that highly rated corporations use to meet their day to day cash needs. These types of obligations are the very financial lifeblood of modern day companies. Without access to these types of funds, many otherwise sound institutions could be in grave jeopardy.

In addition, the Federal Reserve for the first time is now paying banks interest on their required reserves. The FDIC, in an effort to stem any potential bank runs, has increased deposit insurance to \$250,000 from its prior level of \$100,000. Furthermore, the Federal Reserve has been flooding the financial markets with hundreds of billions of dollars of extra liquidity. After a near run on money market accounts, the U.S. Treasury is now guaranteeing money market balances without a dollar limit (for those funds in place as of September 18). And finally, the U.S., along with other major economies, orchestrated a global cut in overnight interest rates on October 9th. So far, these actions have not stemmed the tide.

Our near to intermediate term inflation concerns have largely evaporated in recent weeks. Unemployment, while still at historically modest levels, has risen meaningfully in recent months to 6.1%. The U.S. factory utilization rate at 78.7% is now several percentage points beneath its 20-year average. Commodity prices have seen sharp declines with oil in recent days having declined beneath \$80/barrel and bellwether copper having declined by more than 30% in the last couple of months.

To use a mixed metaphor, the fruits of the United States’ real estate bubble have truly come home to nest in recent weeks. After years of

lending to poor quality, i.e. sub-prime, borrowers at Congress’ express instruction, the nation’s two largest mortgage lenders (Fannie Mae and Freddie Mac) were nationalized in early September in the face of sharply escalating loan losses.

Days later, the 160 year old investment bank Lehman Brothers was allowed to fail after it was brought to its financial knees by bad real estate investments (which could also be called unsuccessful speculation). Shortly thereafter, another major investment bank, Merrill Lynch, was forced to the altar for a shotgun wedding with Bank of America in the face of rapid deteriorating investor confidence.

Concurrently, the nation’s largest savings and loan, Washington Mutual, was declared insolvent and its remaining assets turned over to JP Morgan Chase while the world’s biggest insurer, American International Group, was effectively taken over by the federal government in exchange for an \$85 billion loan.

The freezing of global credit markets has greatly impacted consumer psychology. While previously the economy had been dancing close to a recession, we are now convinced that the U.S. has now entered into a recession. Consumer spending which had been growing modestly earlier in the year saw declines in both July and August. Final numbers for the 3rd quarter will likely show a decline of more than 3%, the first quarterly reduction since the recession of 1990 and the steepest decline since 1980.



While we are deeply concerned about the current economic and market crisis, we are equally confident that the foundation of the United States' economy remains sound. Despite the current turmoil, certain basic truths remain unchanged. The U.S. continues to have an unparalleled entrepreneurial culture, a highly educated work-force, a world class national infrastructure, a highly respected legal system, an engaged political dialogue and deep access to capital. Moreover, we have a government and central bank which are increasingly engaged in resolving the current deadlock and are ready to use all tools available in their arsenal to cure the current grave malaise.

As previously stated, we now believe that the U.S. is in recession. The question at this stage remains the length and severity of this economic decline. With concerted action from the major global players, we believe that the long-term impact of the current situation can be substantially reduced.

Market Comments

For the moment, fear rules the financial markets. The broader U.S. stock market has declined by more than 30% since the start of September. Global stock market losses have been similar with the Russian stock market functioning only sporadically.

The fixed income markets, which are far larger than global stock markets, have fared no better. Effectively, there have been no buyers in large segments of the fixed income market for the past several weeks. The corporate, junk and municipal bond markets have had one of their worst months in decades with declines in excess of 4% for each sector. Only the

Treasury sector showed gains as investors sought the certainty of receiving their funds back.

While the technical term for the current market environment is a "negative feedback loop," we simply call it a panic. The volatility index which measures expectations for future market risk is now 50% above its record highs and has increased more than 250% since the beginning of September. In their desire to protect their existing assets, investors for the first time ever have been willing to accept negative returns by buying U.S. Treasuries just in order to be sure that they received their original principal back (minus the slight negative return.) Renowned investor Warren Buffet has stepped in and placed billions of dollars in new investments in both General Electric and Goldman Sachs.

A major money market fund lost money on an inappropriately large and aggressive bet thereby creating a near panic for these cash like investments. Only federal government promises of guaranteeing existing money market funds was able to quell this budding panic.

These are not the financial markets with which any of us are familiar. We are seeing the most tumultuous markets since the depths of the Great Depression. That being said, we have far more engaged, powerful and knowledgeable central banks and governments than existed 80 years ago. In fact, the developed world's central bankers are meeting the weekend of October 11/12 to coordinate action for future measures to address this continued dilemma.

As discussed in previous letters, the de-levering of the global economy is now occurring. We are entering into an era of substantially greater governmental involvement/regulation in the

financial markets. With the view out of our rear view mirror, this is not a bad thing.

Analyst Corner

It is a self evident truth that stocks are far less expensive today than they were 12 months ago. To look at relative stock market value, we decided to examine stock price earnings ratios for the S&P 500. Taking a longer term perspective, we decided to look at the average P/E ratio over the past five years. With the current market ratio below 12, stocks have not been this inexpensive since the mid 1980s. When examined using a 10 year earnings average, stocks look a bit pricier with the P/E ratio being around 14, its lowest relative level since 1988.

However in looking at valuations on this metric, a key future component, earnings, is unknown. In the face of a national slowdown, and possibly a global slowdown, it is likely that current earnings are higher than they will be in the near future. We are merely trying to highlight how stocks are becoming very inexpensive based on historic norms.

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