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Financial Market Update – September 18, 2008

Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy, and time of maximum optimism is the best time to sell.

-Sir John Templeton

The US stock market dropped 449 points yesterday, one of the worst days in a series of bad days this summer. Today the market rebounded 410 points. The financial services industry has been roiled recently by a series of high profile failures, the most recent ones being Lehman Brothers and AIG. Unfortunately, they are unlikely to be the last. The financial services industry is under siege right now because of years of poor credit analysis and high leverage. As much as we may enjoy seeing these extremely highly compensated individuals (though as a practical matter most of them have already been paid and what is happening currently will have little impact on them) punished for their greed and incompetence, the fact remains that the financial services sector is important to all of us. These companies provide the financing for business expansion, mergers, restructurings, etc. If they are not in a position to lend money, the whole economy can be affected. When liquidity dries up, investors tend to look at businesses in terms of worst case scenario. This is what is happening right now.

In order for a manager to outperform their benchmark they have to take advantage of market inefficiencies. These inefficiencies tend to be greatest when fear and greed are at extreme levels. When investors are greedy, managers have to begin to get defensive. In the short run, that subtracts from performance as stock prices ultimately make their top. Later, it pays off when stocks begin their descent and the defensive moves result in smaller losses. Similarly, managers have to look at extremes of fear as opportunities as well.

Having managed investor portfolios through the 1987 crash; the Kuwait invasion in 1990; the Long-Term Capital crisis in 1998; 9/11 and its aftermath; and the lows of July 2002, we can say that they were all very difficult times to be in the market, but the investment returns in every case from sticking with it and not bailing out were substantial. Moreover, the rare few who found the strength to add to their investment positions during these crisis periods were especially well rewarded.

For example, let's say that an investor wanted to exit the market until conditions seemed more favorable. They have two decisions to make: one, where to put their money now, and two, at what point they will put their money back in the market. Regarding the first, getting out of the stock and bond markets means going into the money market, where yields are below 1.5% (in some cases they are close to zero). Given that inflation has been rising at over 4% over the past year, this safety today comes at the price of certain loss of purchasing power. If you wish to earn a higher yield in a CD you must lock up your funds for a certain time period, which means that whenever the financial markets recover you almost certainly will miss the often initial explosive first few weeks.

The second decision is even more difficult. How do you know when the market has made a decisive upward turn? By definition it isn't a gain of 300 or 400 points over a day or two, because we've already seen that several times this year. Is it 800 points, 1,500 points? If you wait that long you will most likely miss much of the rally. In our experience, the psychological benefits of getting out of the stock market are not as beneficial as one would think. Unfortunately, when investors get out of the market they tend to stay out until the uptrend is well established because they don't want to be faked out. More often than not by that time stocks are often higher than they were when the investor got out. If stocks go down 15% or more from here, there is a reasonably good chance you can get out and get back in at or below where you got out. If the decline is much less than that, statistics and experience both tell us that getting out of the market will be a very costly decision. If you were getting 7% or even 5% interest while you were waiting for conditions to improve, there might be some merit in it. But that just isn't the case right now.

In anticipation of an upcoming difficult stock market over a year ago we have accumulated a larger than normal cash position in your accounts. From our standpoint, our next major decision has to be when to put that cash back to work. We can't help you achieve your financial goals by panicking in the face of difficult conditions. We get through tough times by taking some profits when prices are still good and by moving from aggressive funds and aggressive sectors to more conservative ones such that market sell-offs won't hurt as much. We feel that we did take the all the appropriate steps after which there was nothing left to do but hold tight.

As we mentioned before, recoveries in the stock market can be very explosive. From the October 9, 2002 low stocks rallied over 15% by the 21st (only eight trading days). There have been numerous rallies of 20%+ over several months that have sprung from oversold trading conditions such as we have now. Of course there are risks, but we like the intermediate and long term risk/reward trade-off from these levels. It is a lot easier to earn a 10% long-term investment return in the stock market today from these levels than it was a year ago.

Remember, stocks aren't just tickers and numbers. They represent the collective energy, intelligence, creativity, and hard work of millions of workers in thousands of companies. Long-term, you want to be betting on them, not against them.

The bottom line is this: The stock and bond markets are both in a state of panic right now, and by definition panic is hard to predict. Sometimes it resolves itself, other times it requires powerful outside forces such as government intervention. Sometimes it takes a cathartic sell-off to force out all of the investors with "weak hands". Long time pros have a saying that bear markets are when stocks return to their rightful owners. This bear market is scary, but a lot of opportunity is being created. As John Templeton said, times of maximum pessimism are the best times to buy.

You should have received a note from us on money market funds. We are here to help you meet your financial goals by helping you get through the tough times. Please call us if you have any questions or concerns with regard to your portfolio.

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