

Second Quarter 2008 – Market Review

Bleak. Apparently we live in a bleak, bleak world. In the second quarter oil prices continued to rise. The cost of corn, wheat, rice and other food stuffs rose. Inflation is accelerating. At the same time, the economy is stagnating. Politicians are blaming oil companies, the oil producing nations, the Chinese, commodity market speculators, and anyone else that happens to amble by. By now \$107 billion of economic stimulus checks will have been received by 130 million American households. It appears that most of that money went to pay for higher gasoline costs. The financial markets are in turmoil. There is a great deal of concern about the condition of almost all financial stocks. Several financial sector indexes are down 50% or more from their highs. The media is doing a great job; the outlook is bleak and everyone is scared. Day after day, it seems, the markets fall and oil prices rise.

According to Gregg Easterbrook at the Brookings Institution, a recent CBS News/New York Times poll showed that 81% of Americans believe that the nation is on the wrong track – the worst ever number for this barometer. Campaigning in Pennsylvania in April, Hillary Clinton said “We need to go back to the prosperity of the 1990s,” a comment that drew loud, enthusiastic applause. This is strange, because converted to today’s dollars, per-capita income in the Keystone State is now 23% higher than in 1990. People may think Pennsylvania was more prosperous in the past, but the state is better off today. In fact, according to Easterbrook, in most parts of the country, per-capita income is the highest it’s ever been.

When asked about the country’s economy, schools, health care or community spirit, Americans tell pollsters the situation is dreadful. But when asked about their own jobs, schools, doctors and communities, people tell pollsters the situation is good. Our impressions of ourselves and our neighbors come from personal experience. Our impressions of the nation as a whole come from the media and from political banter, which both exaggerate the negative.

Asset Class Returns - Before the Impact of Inflation						
	Investment Type (Index)	2 nd Qtr	1 Yr	3 Yr	5 Yr	10 Yr
Equity	Large Cap (S&P 500)	-2.7%	-13.1%	4.4%	7.6%	2.9%
	Broad-Market (Russell 3000)	-1.7%	-12.7%	4.7%	8.4%	3.5%
	Large Cap Growth (Russell 1000 Growth)	1.3%	-6.0%	5.9%	7.3%	1.0%
	Large Cap Value (Russell 1000 Value)	-5.3%	-18.8%	3.5%	8.9%	4.9%
	Mid Cap (Russell Mid-Cap)	2.7%	-11.2%	6.8%	13.1%	8.1%
	Small Cap (Russell 2000)	0.6%	-16.2%	3.8%	10.3%	5.5%
	International Equities (MSCI EAFE)	-2.3%	-10.6%	12.8%	16.7%	5.8%
	Commodities (Dow Jones AIG)	16.1%	41.5%	19.8%	18.6%	13.0%
	Real Estate Investment Trusts (NAREIT)	-4.6%	-11.9%	10.9%	17.5%	11.9%
Bonds	Gov't & Corporate Bonds (Lehman Gov/Credit)	-1.5%	7.2%	3.8%	3.6%	6.0%
Cash	Cash (T-Bills)	0.5%	3.8%	4.3%	3.2%	3.5%
	Inflation (CPI)	2.5%	5.0%	4.0%	3.6%	3.0%
Asset Class Returns - After Inflation						
	Investment Type (Index)	2 nd Qtr	1 Yr	3 Yr	5 Yr	10 Yr
Equity	Large Cap (S&P 500)	-5.2%	-18.1%	0.4%	4.0%	-0.1%
Bonds	Gov't & Corporate Bonds (Lehman Gov/Credit)	-4.0%	2.2%	-0.2%	0.0%	3.0%
Cash	Cash (T-Bills)	-2.0%	-1.3%	0.3%	-0.4%	0.5%

“Absurdity, n.: A statement or belief manifestly inconsistent with one's own opinion.” Ambrose Bierce

So why do the vast majority feel so down? As we've discussed before, the news media does such a great job of spreading doom and gloom. Now we don't just hear about business failures or job cut backs, but we see immediate live footage from all corners of the world, creating the impression that threats and disasters are everywhere. Bear Stearns collapses and the financial markets meltdown right in front of our own eyes. We have a heightened sense of all that's bad, forgetting that the vast majority of mortgages won't default and that most people still have paying jobs.

Upon hearing, seeing and feeling the news, our human desire to do something screams at us to take action, any action. But, often our own actions can make the situation worse for ourselves. Simply selling things that have not performed well or changing investment direction now, after a significant decline in the markets can make the situation even worse for us. Here's our simple recipe for success:

1. **Have a plan and stick to it.** If you are uncertain what it will take for you to live your life in financial security, find out. This is one of the most important things we do for our clients. Knowing that you are on track to meet your goals, even after a market decline, allows you to stay the course and ignore the distractions.
2. **Take only the risks you need to take.** This means diversification. It is the only free lunch in the investment world. The single biggest risk one can take is holding too much of a single investment. It doesn't matter what company it is, holding too much of it is very risky. Remember all the employees who own or owned company stock in Bear Stearns, Ford, Fannie Mae, IndyMac, Worldcom and countless others. Some lost everything because of fraud and others lost next to everything from management incompetence and/or unpredictable events that occurred along the way. No company is immune to bad luck.
3. **Understand how markets work.** Being diversified doesn't mean that your portfolio won't go down. You can't diversify away market risk. Markets fluctuate because people are involved. People's rational and irrational decisions drive the markets. Understanding this allows you to benefit when others are fearful.
4. **Now is a great time to invest.** For those who are saving money, weak financial markets are a gift. And, the longer it lasts the better off you'll be. Take this opportunity to save and invest more. You'll be amazed at how much money you'll make from investing during periods like this.
5. **Do no harm.** If you are on track with your plan, are well diversified, understand that markets fluctuate (sometimes wildly) and don't have any additional monies to invest, now is the time to practice benign neglect. It will work out.

As advisors, we can help with the first two. We develop plans and design portfolios to support your plans. We can help you understand how markets work, but it is up to you to save money and/or stay the course.

Unfortunately, we cannot help you avoid market downturns, but we can help you find ways to reduce volatility. We are unable to predict where the markets are heading, but we can help you to head in the right direction. We may not be able to ensure that your portfolio tracks a market index – what's really relevant is that you remain on track to meet your goals, regardless of benchmark performance. By keeping these things in mind, the short-term bleakness will give way to longer term success.

"I made most of my money investing in bear markets, I just didn't realize it at the time."

Shelby C. Davis (who turned \$100,000 into \$800 million over the course of a 45 year investment career)

Important Note: Past performance is no guarantee of future results. Please do not assume that any information contained in this Insight serves as the receipt of, or as a substitute for, personalized investment advice from Madison Wealth Management.