Lassus Wherley ...a view from the top

Building Better Futures

Issue 7: June 2008

"Is It Over Yet?"

I wish I could say that it is over. Unfortunately, there are still many unknowns hanging over our heads. We have begun to see some positive signs that the subprime mess may be working through the financial system but we are also seeing some earnings reports that are less than expected. Every week the news is something different. So, with some good news, we have reason for a little optimism amid all the doom and gloom. Unfortunately, we had a pretty significant retracement of previous lows in the markets yesterday, Thursday, the 26th of June, and some continuation of this downward movement. That's Wall Street speak for the market went down a lot. As always, this market is reacting at a very emotional level to good and bad news. The most recent drop was a reaction to several doses of bad news, including concern about inflation.

Although we never try to use our crystal ball, companies are more realistically valued in today's market. This suggests we may be approaching a period where we could begin to see more good days than bad.

As I was reviewing some of the performance numbers, I realized just how well our diversification strategy has worked over the last year. We certainly have experienced losses in our portfolios, but the losses have been much less than those in the overall equity markets. Here is the performance of some of the indexes that we track:

	5/31/2008			6/26/2008
Index	3 Yr	1 Yr	YTD	YTD
S&P 500	7.57%	-6.70%	-3.80%	-11.70%
Russell 2000	7.95%	-10.54%	-1.81%	-8.23%
MSCI Intl	16.61%	-2.53%	-3.03%	-10.53%
Lehman	4.30%	6.89%	1.21%	.85%
Aggregate Bond Index				

This continues to be a market where we have to keep reminding ourselves that the fundamentals of investing are more important than ever and………. ***we are long-term investors***.

Thanks to everyone for providing the many thoughtful questions that make up our current issue. ***Diahann***

The following section discussing the risk associated with custodians was authored by Deborah J. Rivosa, CFP®, CFA.

Question: *In light of the news about Bear Stearns, how safe is my custodian?* **Answer:** First, Bear Stearns had a long - standing reputation for being an aggressive risk taker in the investment banking business. Bad investment decisions and too much borrowed money led to huge losses, and they could not continue to cover their losses with more debt. High-risk, falling portfolios led investors to demand their money back, and at the same time, lenders were unwilling to lend them more money. The result was a liquidity crisis and the bailout by JPMorgan Chase on March 14th with the backing of the Federal Reserve.

To address our clients' individual preferences and for different situations, we work with three custodial platforms: Charles Schwab, Fidelity Investments and National Advisors Trust. None of these custodians are in the investment banking business, and they take very seriously the safety and protection of clients' assets.

Charles Schwab provides securities brokerage and financial services to individual investors and the independent advisors who work with them. They are financially sound and remain dedicated to their continued financial health. Their capital structure and liquidity are extremely strong. They are committed to risk management, and their internal controls and business standards are designed to keep clients' assets safe.

Fidelity Investments is one of the largest providers of financial services and also the largest mutual fund company in the U.S. Protecting client assets is one of their top priorities. The combination of extensive internal controls, regulatory oversight and asset protection programs provides comprehensive and effective safety of client assets.

National Advisors Trust is a federally chartered trust company, which enables us to provide a low-cost alternative to traditional trust service providers to our clients. By law, client assets are segregated from the capital assets of National Advisors Trust and are not subject to potential creditor claims. National Advisors Trust has no exposure to the subprime market because they do not provide investments at any level. They provide custodial services and act as Trustee when required.

The bottom line…investing in mutual funds as we do involves substantially less risk than accounts with Bear Stearns or other investment banks where they are always leveraging to increase profits. The silver lining is that the subprime loan debacle and its aftermath are out in the open. Right now everyone is seeing the absolute worst in every respect, but we will get through it. In this environment, we believe maintaining a long-term focus with fully diversified strategies is critical, particularly since economic weakness looks like it may continue for a while, and the effects of monetary and fiscal stimulus will begin to diminish.

The following section on inflation was authored by Anne M. Kehl, Investment Officer. Anne joined us recently and is part of our Investment Committee.

Question: *Just what is inflation?* **Answer:** The classical definition of inflation is a ***sustained*** increase in the overall price of goods and services in the economy. Moderate inflation is associated with economic growth and is usually beneficial for stock prices. High inflation can mean that the economy is overheating and is usually very negative for all financial assets. If economic growth is too strong, demand accelerates and prices go up continually. An upward price spiral may result in runaway inflation which, in turn, could severely dampen the growth which started it.

Question: *Why should investors be concerned about inflation?* **Answer:** Inflation erodes the value of currency, investments, income and purchasing power because prices increase with no corresponding increase in value. We calculate the real rate of return on investments by subtracting the rate of inflation from the nominal return received. The real rate of return is a better indicator of the growth in purchasing power which we are achieving as investors. To sum up, all things being equal, the real rate of return decreases as the rate of inflation increases.

Question: *What causes inflation?* **Answer:** In the U.S., inflation is often described as "too many dollars chasing too few goods." This occurs in periods of strong economic growth when spending outpaces the production of goods and services, and the supply of dollars grows to exceed the amount needed for financial transactions. Some economists, called monetarists, would argue that inflation is the result of the Federal Reserve making money too readily available by cutting interest rates and taking other measures to increase liquidity in the economy. Monetarists are concerned that the very easy monetary policy which the Fed has been pursuing since last summer will sow the seeds for the next round of inflation.

Rising commodity prices are also seen as a major cause of inflation. When commodities rise in price, the costs of basic goods and services generally increase as businesses attempt to stay ahead of the rising prices. Dramatically rising oil prices, such as we have now, led in the 1970's to a period of stagflation, or a period in which the economy slowed but inflation remained higher than normal. Avoiding either stagflation or a major uptick in inflation is the major concern of the Federal Reserve at present. Keep in mind that the Fed has a dual mandate – to keep both unemployment low and inflation contained. This is always a delicate balancing act but perhaps never more so than now.

Question: *Why are stocks and commodities considered a better hedge against inflation than bonds?* **Answer:** Common stocks provide a hedge against inflation over the long term due to the fact that companies can raise prices for their products when costs increase due to inflation. Higher prices can translate into higher revenues and earnings. Dividends paid on common stock can also help protect against inflation if they increase at a rate that is at least equal to the rate of inflation.

Commodity prices and investments in commodity funds actually rise with inflation. The strength in commodities we have seen in recent years is due in part to the rapid rate of economic growth in the emerging economies, particularly China and India. While investments in commodities have provided far superior returns to other asset classes over the past few years, we are watching this investment class carefully for signs of overvaluation. The economies of China and India are also beginning to weaken as the U.S. and Europe slows. Also, the recent spate of natural disasters is likely to have a dampening effect, especially in China.

In times of increasing inflation, bonds are particularly vulnerable as the purchasing power of the stream of interest payments received by bondholders continually erodes. This is because the rate of interest or coupon on most fixed income securities remains the same until maturity. At the same time, rising inflation erodes the value of the principal of fixed income securities. Finally, when interest rates rise in anticipation of higher inflation, bond prices fall.

Question: *How is inflation measured?* **Answer:** The two most widely monitored indicators of inflation in the U.S. are the Producer Price Index (PPI) and the Consumer Price Index (CPI). Of the two, the Consumer Price Index gets more attention. Many government contracts, including social security payments, are linked to changes in the CPI.

The CPI is a measure of the average price level of a fixed basket of goods and services, including housing costs, transportation and healthcare which are purchased by consumers. Monthly changes in the CPI represent the rate of inflation. Due to the volatility of food and energy prices, economists prefer to look at the core CPI instead of the overall CPI. The core CPI excludes food and energy.

Larger-than-expected increases in core CPI can lead the Federal Reserve to raise interest rates in an effort to prevent inflation from accelerating. The rate of inflation is key in determining interest rates.

Question: *How has inflation been running according to these measures?* **Answer:** Consumer price inflation in April came in better than expected. The overall April CPI showed a fair amount of inflation, rising .6%, compared to the .2% seen in April. On a year-over-year basis, the overall CPI rose to 4.1% from 3.9%. The core CPI (excluding food and energy) came in at 0.2% vs. 0.1% in April. The core CPI on a year-over-year basis was unchanged at 2.3%. The report confirmed the Fed's worries about the trend in inflation. Since the release of the report on June 13th, the Federal Open Market Committee has voted to keep their target interest rate unchanged at 2%. The Fed statement after their meeting this week, however, made clear that inflation has replaced growth as their number one concern.

Question: *Just how concerned should we be about inflation at present?* **Answer:** As long as investors remain convinced that the Federal Reserve will act appropriately to address inflation risks, then inflation pressures should remain contained. We are of the belief that the Federal Reserve had no real choice but to cut rates and to aggressively provide liquidity to the financial system since the subprime mortgage crisis began last August. The fact that liquidity had almost dried up by the time of the near-collapse of Bear Stearns in March meant that extraordinary measures were called for to keep the financial system functioning.

Fed Chairman Bernanke certainly faces significant challenges in conducting monetary policy, given the weak economy and growing threat of inflation. We believe he is up to the task. The Fed expects inflation to moderate later this year and into next year as tight credit, the continued weakness in housing and high oil prices depress growth. First-quarter earnings reports showed that the weak economy was making it difficult for companies to pass on cost increases from higher commodities prices. Investors will be carefully monitoring second-quarter earnings releases to see if there has been any change in this regard. The weak employment picture and the option of overseas outsourcing have also constrained labor costs. Both productivity and unit labor costs in the first quarter of 2008 came in better than expected.

Finally, after the dramatic recent run-up in crude oil prices, there is reason to believe that we may be close to a near-term top or high in prices. Demand destruction is occurring at these levels. The Saudis may well increase production and any move by the Fed to raise rates will make the dollar more attractive and commodities less attractive. As always, inflation bears monitoring. We are encouraged that the Fed has expressed their concerns in this regard and signaled that their next move will be a rate increase.

Question: *Hussman Strategic Growth has done pretty well in this market. What type of fund is it and why has it done better than other stock funds?* **Answer**: This fund is in the category we call hedge strategies, and we use these funds to help "hedge" the risk of the financial markets. The manager, John Hussman, uses options, shorting stocks and other defensive techniques to protect against market declines. In 2001 and 2002, both down years, Hussman's fund returned 15% and 14%, respectively. Since the fund's inception in 2000, it has never lost money in a calendar year or dropped more than 2.3% in any quarter. It has held up pretty well in the current crazy markets. Since the housing and mortgage crises increased in the middle of last year, the S&P 500 dropped close to 6% as of the end of May, and the typical long-short fund was down 1% while Hussman was up 2%. So far, it has even had a positive return in June which is really good in this very negative market.

Question: *How will the election affect the markets?* **Answer:** The impact on the markets will initially depend on which party is elected, but the first year the results will probably be comparable. Odds are that either candidate will allow the current low long-term capital gains tax rate of 15% to expire, which would raise the rate to 20%. We all know that it takes time for a transition team to move in and appoint all the new players and then actually start trying to implement changes. So…...the odds are pretty good we won't see much in the first 12 months except emotional reaction to what people think MAY happen. After that there could be changes that affect us, but my crystal ball doesn't want to hazard a guess on 2010 yet.

Question: *What are inflation-indexed bonds?* Inflation-indexed or inflation-linked bonds are designed to protect the purchasing power of an investor's savings by indexing interest and principal payments to consumer prices. If prices go up, so, too, do dollar payments from an indexed bond. The Treasury started its indexed bond program in January 1997 by issuing 10-year inflation-protection bonds, with principal and interest payments linked to the consumer price index for all urban consumers (CPI-U).

These bonds give investors two different payments: Inflation Payment—every six months, the principal is adjusted by an amount equal to the CPI, payable only when the bond is old or matures. Interest Payment—bondholders or bond fund receives a check twice a year for an amount equal to the principal multiplied by the interest rate. In the unlikely case of deflation, the adjustment can go down, but never below par. For example, suppose an investor purchased a $1,000 TIPS with a 4% real rate of return coupon (payable at 2% semiannually). If inflation over the first 6 months was 1%, the bond's principal would be increased to $1,010 ($1,000 times 1.01), and the first semiannual coupon payment would be $20.20 ($1,010 times 2%).

There is one catch. The IRS taxes the inflation-adjusted increases in principal, which are not paid until the security matures, under the rules OID. This policy, as it does for zero-coupons, creates taxes on phantom income, which can be a real nuisance for taxable accounts. Like any investment, we have to weigh the positives and negatives and determine whether or not it makes sense for an individual client.

Keep those questions coming in. You ask great ones and many of them we can share with everyone else.

Have a great summer!

Food for Thought

"I am more and more convinced that our happiness or our unhappiness depends far more on the way we meet the events of life than on the nature of those events themselves." -Karl Wilhelm Von Humboldt

"The most influential person who will talk to you all day is you, so you should be very careful about what you say to you!" - Zig Ziglar

The happiest people I know are those who have learned to live beyond their own special interests by discovering the rewards that come from giving of themselves. - Winfield C. Dunn

"Realize that true happiness lies within you. Waste no time and effort searching for peace and contentment and joy in the world outside. Remember that there is no happiness in having or in getting, but only in giving. Reach out. Share. Smile. Hug. Happiness is a perfume you cannot pour on others without getting a few drops on yourself." - Og Mandino

"I think the purpose of life is to be useful, to be responsible, to be honorable, to be compassionate. It is, after all, to matter: to count, to stand for something, to have made some difference that you lived at all." - Leo C. Rosten

Apathy can be overcome by enthusiasm, and enthusiasm can be aroused by two things: first, an idea which takes the imagination by storm; and second, a definite, intelligible plan for carrying that idea into action." - Arnold Toynbee