Lassus Wherley ...a view from the top

Building Better Futures

Issue 4: August 2007

"The Roller Coaster is Back"

Increased Market Volatility

So far 2007 has been a very challenging year for investors. We almost need motion sickness pills with the fast up-and-down movement of the financial markets. This is truly a market where we have to keep reminding ourselves that the fundamentals of investment are more important than ever and ***we are long-term investors.***

There have been many factors adding to the turbulence we have seen in the U.S. and international stock and bond markets. I will cover a few of them in a question and answer format below.

Questions and answers about the current market:

Question: What is the subprime market that everyone is talking about? **Answer**: Subprime mortgages are loans made to individuals who have bad or sometimes no credit history. They pay a higher interest rate because they are more likely to default. Many of the subprime loans made during the housing boom were high risk with variable interest rates or interest-only. This increased the risk level of default since the mortgages could end up being higher than the value of the house when house values began to fall.

Lenders didn't want to hold these mortgages, so they would package them or bundle a group of them together and sell them to other banks and/or investors such as hedge funds. As the housing markets slowed and interest rates began to rise, more of these loans began to miss payments and could end up in default. Institutions, hedge funds and other investors who bought these loan packages began to lose money as the values started going down.

Question: How have the problems in the subprime market caused the stock markets to decline? **Answer**: As the values of both subprime and regular mortgages began to go down, the number of buyers also went down. Investors weren't willing to buy until they were sure of the real value of the mortgages. In the short term, the value is very difficult to determine. So…….as the hedge funds and other investors needed cash, they were forced to sell other more marketable assets such as stocks. This led to a broader market sell-off in stocks both in the U.S. and globally.

Question: I understand it is getting much harder to get a mortgage or equity line because of this market. Should I be concerned? **Answer**: Since mortgage lenders normally package and sell mortgages to others to raise cash for making new loans, it will become more difficult to get loans. However, if you have good credit, you should be able to get a loan. It may be more expensive than it would have been a few months ago, and you may need to work harder to get the mortgage, but it should be available.

Question: I thought the reason we own many different asset classes was that they go up and down at different times, but it seems like everything has gone down in the market. Why is that happening? **Answer**: Sometimes fear is the major driving factor for the financial markets. There are certainly problems in the mortgage market, but much of the volatility can be attributed to fear. Much of the fear is driven by uncertainty. Because no one knows exactly how this situation will unfold or what the timeline will be, there is much speculation, including looking at all the worse-case scenarios. During periods like this, investors become extremely sensitive to any kind of news at all. Any negative news is magnified 10 -fold by the time it works its way through the markets. This means we end up throwing the baby out with the bath water. The markets really haven't focused on whether something is a good or bad investment. Much of this is still being driven by hedge funds and other investors who need cash for redemptions to pay back investors or for other reasons.

During these periods, there aren't many asset classes that are going to do well. The only thing that has made money has been some of the corporate bonds and some of our hedge strategies funds that were betting on a down market. These instances usually last for short periods of time before going back to trade on future expectations of the economy. We have experienced this type of market in the 1990's and will experience it again in the future.

Question: What are the positives we can take away from this crazy environment? **Answer**: The subprime market is actually a very tiny part of the overall mortgage market. The worse-case scenarios show that only 14 to 20% of those with late payments may actually default. The economy is still strong both in the U.S. and around the world. We are feeling the slowdown in real estate but the U.S. economy is still growing and inflation is still under control.

Question: Should we be doing anything different with our investments based on what is happening? **Answer**: The short answer is no. Every investment plan is designed for the long term. Adjustments are made based on your changing needs or on fine-tuning we may do. Since we review for adjustment on an on-going basis, we have been making slight changes over the last year or so. We have limited our exposure to mortgage securities funds over the last few years and reduced our exposure to high-yield securities funds.

Question: What is a "carry trade" and why is everyone talking about it now? **Answer**: A "carry trade" is a popular strategy where investors borrow money in countries with low interest rates, such as Japan, and invest it in countries with higher interest rates. This has been a source of high profits for currency speculators, companies and hedge funds. As the subprime issue evolved in the U.S., investors no longer wanted to own these riskier, higher-yielding assets. Investors have begun to reverse these trades to pay back the loaned assets driving up the value of the yen against other currencies, including the dollar.

Let us know if you have other questions concerning the economy and the financial markets. Also, please keep in touch to make sure we are aware of any changes in your overall financial circumstances that may require a change in your investment strategy.

Enjoy the last of the summer.