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3rd Quarter 2007 Newsletter

Volatile Quarter for Equities and Bonds

The third quarter of 2007 saw the first significant drop in the equity markets after a multi-year bull market. Within one month, the broad market index corrected (declined) about 10%, and by the end of the quarter were back to their old highs as measured by the S&P 500 Index.

The relatively low interest rate environment around the world contributed to a sustained market rally dating back to the spring of 2003. This is when the market started a serious recovery from the bear market that saw the S&P Index lose about 40% of it's value.

The primary concern was the large number of sub-prime mortgages that had been made available by lenders over the last few years, and the now higher interest rate environment will affect these mortgages. A Wall Street Journal article reported that one out of seven adjustable rate mortgages established in 2006 had interest rates of less than 2%. Those will need to be refinanced at much higher rates, creating a large increase in overhead for those families.

The Federal Reserve came to the rescue with a substantial decrease in the federal funds rate and the discount rate, or overnight lending rate that banks charge each other for credit. This was in spite of the individual Fed Governor's statements in the weeks prior to the rate reduction indicating that the Fed should not be in a position to bail out the equity markets.

Equities were not the only asset class hit with a broad market decline in the quarter. Bonds and fixed interest debt instruments also felt the effects of a rapid evaporation of liquidity and easy money for borrowing in the markets. Commercial real estate, as measured by the REIT index, also saw substantial declines after years of out-performing the general equities market. The REIT index dropped close to 20% before a recovery began.

Our actively managed programs are designed to reduce exposure to asset classes exhibiting downside volatility, and we were able to avoid much of the decline over the one month period when equity markets around the world saw a correction (decline).

Historical Perspectives

Twenty years ago on October 19, 1987 the stock market experienced one of the most volatile short-term swings in history. During the year preceding the crash of 1987 the Federal Reserve had been raising interest rates to slow down an overheated inflation environment. 30-year Treasury yields were around 10%, compared to about 4.8% today. Back then the price of a barrel of oil was $19.80 compared to today's price of just over $80.00 per barrel.

Allen Greenspan had taken the helm of the Federal Reserve about ten weeks prior to the 1987 October crash, and had another 18 ½ years afterward running the Fed to remember the consequences of the Fed action during that time period.

In the three trading days prior to black Monday, the S&P 500 Index had fallen a little over 10%. This was just about eight weeks after the S&P had hit an all time high in late August. At that point in time the S&P was up a remarkable 41.2% year-to-date. By comparison in 2007 the S&P 500 Index hit a high point at 11.9% year-to-date in early October.

On black Monday October 19, 1987 the S&P 500 fell 20.5%, which was the largest single-day percentage drop in the history of the index. On Tuesday the Index bounced back up about 5.3% and on Wednesday it bounced 9.1%. It took the stock market a little over a year to recover from the single day losses that occurred on black Monday. Before the fall, the market as represented by the Index had a price earnings ratio of 23, compared to a P/E of 18 in today's market environment. A company's (P/E) price-to-earnings ratio is equal to a company's stock price divided by its earnings per share. P/E ratio compared over time, along with other factors, may provide insight into under-valued and over-valued stock markets.

Today the economy is much more diverse and resilient that it was 20 years ago, and restrictions have been imposed on the broad market exchanges to collar the market during periods of extreme volatility. The chances of another 1987 market crash are much lower as a result of these changes over the last 20 years.

Collaring Market Volatility

Our active asset management programs are designed to identify periods of increased down side volatility, and reallocate monies to those asset classes that may be less vulnerable to these market forces. In addition to the risk management our systems impose, we also look for opportunities in asset classes that have potential for gain. If there aren't any likely candidates, we reposition in money market funds, which have no market risk, and provide some income while we patiently wait for another opportunity.

Last Quarter of the Year

The three months of October, November, and December have generated 63% of the entire total return achieved by the S&P 500 stock index in the 17 years from 1990-2006. The S&P 500 is an unmanaged index of 500 widely held stocks that is generally considered representative of the US stock market. (Source: BTN Research).