



WEALTH DIMENSIONS

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The future has a way of arriving unannounced.

George Will

The recent events that have unfolded in the credit and global equity markets have been nothing short of stunning. We have been in this business a long time and experienced many market conditions over the last 25 years. The abrupt market crash of October, 1987 has always been remembered as one of the worst, yet these past weeks may have that beaten. After eight straight days of relentless declines, Friday, October 10 and the following Monday gave new meaning to volatility. Friday started with the Dow Jones Industrials plunging 696 points, rallying 1,018 points mid-afternoon, and then plunging 450 points at the close, finishing the day down 128 points. Friday capped off the worst one week loss for the Dow in history, down 1,874 points, or 18 percent. Friday also saw the highest NYSE volume ever, 11.4 billion shares traded with 87 percent of all stocks in the New York Stock Exchange hitting new 52 week lows, the most ever.

This violent market decline took place in response to a rapidly deteriorating global freeze of credit in virtually all areas of the economy, threatening everything from auto loans to corporate letters of credit. Eventually it began to interrupt the most basic trade and commerce functions in our economy. One of the most potentially devastating interruptions began emerging in corporate letters of credit, where a buyer guarantees payment for deliveries via a letter of credit issued by the buyer's bank. As bank balance sheets became increasingly impaired, their ability and willingness to lend became more selective, banks began pulling existing letters of credit from their customers. Without a letter of credit, companies could no longer secure delivery of raw materials and other items necessary to conduct their businesses.

Governments to the Rescue

Friday afternoon, the finance ministers from the G7 nations met to discuss coordinated solutions to the world banking crisis. They seemed to reach consensus on the need for coordinated policy, but conceded that each country needed flexibility in addressing their specific needs. The European governments emerged from a series of emergency weekend meetings to pledge guarantees for interbank lending and to purchase stock in their battered financial institutions to improve the balance sheets. In total, they pledged over \$2 trillion in government assistance for troubled institutions.

Cheered by the coordinated moves in Europe, the world equity markets skyrocketed Monday as many stock market indexes rose over 10%. The Dow Jones Industrial Average had its largest single day point gain ever rising 932 points. The 11% rise was the largest single day percentage gain since 1933.

Following the European lead, the US Working Group on Financial Markets met throughout the day on Monday and put forth a plan Tuesday for the US government to spend \$250 billion to buy stakes in US financial institutions. The government will initially purchase stock in nine large banks, but the program is expected to be expanded to many others. The initial banks participating will be all of the country's largest institutions, including Citigroup Inc., Wells Fargo & Co., JPMorgan Chase & Co, Bank of America Corp. and Morgan Stanley, but the administration did not provide any amounts that would be received by individual banks.

All of this action will allow the government time to put mechanisms in place to implement other parts of the \$700 billion rescue package that gives the government broad authority to utilize taxpayer funds to buy troubled mortgages and other debt from these same institutions.

Leverage, Leverage and more Leverage

We are clearly in unprecedented times driven primarily by the bursting of the real estate bubble and the subsequent deleveraging of the markets. This issue of deleveraging is central to our current and future situation, so we would like to spend some time on what it means. Throughout the low interest environment of the past several years, financial institutions, such as banks and brokerage firms, and other entities, such as

hedge funds, borrowed money at low rates and invested it with the intention of earning a higher return than the interest they had to pay on the borrowed funds.

Hedge Fund A:	Cash Invested	\$10	
	Loan	\$90	at 4%
	Total to Invest	\$100	
	Leverage Ratio	10 to 1	

Hedge Fund A buys \$100 of mortgage backed securities earning 6% or \$6. The fund pays interest of \$3.60 (4% of \$90 borrowed). The net earnings are \$2.40 (\$6 earned - \$3.60 interest). The return to the fund is $\$2.40 \text{ net earnings} / \$10.00 \text{ invested} = 24\%$ return instead of 6% without the leverage.

Banks and brokerage firms use more complex forms of leverage in conducting their business, but it works essentially the same. The problems arise when the underlying securities that were purchased drop in value below the outstanding loan used to buy the securities. In the example above, if the \$100 of securities falls below \$90, the fund (bank or brokerage firm) no longer has sufficient assets to pay off the loan because their loan exceeds the value of their securities. In some cases, the leverage ratio was extended to 30 to 1. In this case, if the securities fall in value by more than 3%, the fund cannot pay off its loan.

Why is this Important

All of the leverage present in the marketplace made credit readily available under very attractive terms and provided a significant boost to the economy. Many debt products like mortgages, auto loans, student loans, etc. could be packaged in large quantities and sold as a single investment product. These products are referred to by acronyms like CMO (collateralized mortgage obligation) and CDO (collateralized debt obligation). In many instances, purchasers were often highly leveraged and simply looking for interest rates that were above the rate at which they could borrow (cost of funds). These entities could generally borrow at below market rates often linked to the Federal Funds Rate that the Federal Reserve offers to banks. As the demand for this type of packaged product grew, the rates and terms available to retail borrowers became more and more attractive.

The net impact was a huge expansion of available credit that consumers quickly tapped to buy new and more expensive homes, automobiles, furniture, vacations, and other items. We have discussed the rapid expansion of household debt a number of times over the last several years and its potential consequences.

Not to be outdone by the consumer, corporations and private equity firms utilized the available credit to fund mergers and acquisitions as the economy emerged from the collapse of the tech bubble and terrorist attacks on 9/11. Unfortunately, no one was minding the store and credit was extended without proper due diligence and underwriting. As a result, when the housing market began to turn down and interest rates rose from historical lows, borrowers began to miss payments. It soon became apparent that the value of these mortgages and other debt instruments, as an investment, was overstated and began to decline. The contagion became viral as investors appropriately questioned the credit ratings that had been assigned to much of the packaged debt. As credit ratings plummeted, this debt became almost impossible to sell as the once insatiable buyers all became sellers in an effort to unload this debt. Going full circle back to our hedge fund example, many of the buyers had borrowed money to leverage these investments in an attempt to juice returns and now they had to repay their own loans with funds they did not have. When all of the buyers in a market become sellers, you have a crash.

The result is a totally frozen credit market, where the number of sellers exceeds buyers by so much that the markets simply do not function. We have seen the collapse of three of the five major investment banks, Bear Stearns, Lehman Brothers, and Merrill Lynch, the latter saved from extinction by Bank of America. The rate of bank failures is accelerating and it is estimated that as many as 1,000 banks will fail. We have already seen the elimination of such notables as Wachovia, Washington Mutual, and IndyMac. The government's recent announcement of the \$250 billion investment in nine banks is aimed at preventing the systemic risk of the collapse of a bank considered too large to let fail.

Political Contributions

No crisis would be complete without a political component and this one is no exception. In 1999, Congress passed and President Clinton signed the Gramm-Leach-Bliley Act, better known as the Financial Services Modernization Act. This Act repealed part of the Glass-Steagall Act of 1933, which was passed during the Depression to keep banks out of

more risky investment, commercial banking and insurance services. This quickly led to a myriad of large banks entering the investment and insurance business through major acquisitions. In addition, the FSMA incorporated more requirements that banks provide lending services to low income households and that banks essentially could not deny credit based on credit scores in these populations. The goal was to increase the rate of home ownership in America, and it effectively accomplished that goal albeit temporarily.

While primary regulators of many of these institutions were aware of many of the changes taking place in the industry from a leverage and underwriting standpoint, this new legislation promoted behaviors that the regulatory agencies were historically charged with preventing, thus exacerbating the problems.

Here and Now

We once again have a crisis that has been created by excessive risk-taking, frivolity and political interference in the markets. As the Federal Reserve lowered rates to historically low levels, commercial banks, investment banks, and hedge funds quickly identified opportunities to increase their returns by leveraging their portfolios to much higher levels. If they could make profits at 6 to 1 leverage, why not go to 10, 20 or 30? As they increased leverage, their ability to withstand price fluctuations declined substantially and ultimately threatened the entire financial system.

What Will the Future Bring

We are now going through the painful process of deleveraging as institutions attempt to repay their outstanding obligations and consumers adjust to a new world where credit is scarce and living within their income becomes a necessity. The coordinated global response to this credit crisis will begin to restore stability in our financial institutions. For consumers, we have already seen banks reducing limits on credit cards and home equity loans, while qualifying for an automobile loan now requires a credit score over 700. These dynamics are well known and, as markets are relatively efficient, current market prices already reflect the fact that a significant economic slowdown is inevitable. Going forward, the markets will remain volatile and continue to be a predictor in anticipation of economic activity six to nine months in the future.

We don't know what has been worse, the stress of seeing equity values diminish before our eyes or the stress of trying to keep up with the unrelenting news flow. Between the two, most of us can't seem to take even a few hours to "let go of the wire" which only compounds the anxiety. With all of the negative headlines in today's financial news it is easy to be disheartened and even begin to wonder: should I take my losses, sell all of my investments and hold cash for awhile? It is normal to feel anxiety during economic downturns or market turmoil, but emotional reactions to financial news are seldom rational and instead can lead to imprudent investment decisions.

The economy and markets are cyclical and will experience periods of prosperity and decline, with a long-term tendency towards prosperity. We also know that the precise timing of these cycles cannot be predicted with any consistency or accuracy. While economic and market statistics are ever changing, history is the best guide we have to educate us on the volatility that is inherent in investing. Whether it is the Great Depression, World War II, Vietnam, the '70s malaise, 1987, the bursting of the tech bubble or today, the fundamental principles still apply. Diversification, the relationship between risk and reward, and the power of time are central tenets of successful investing that are rooted in the very heart of free markets and capitalism.

In order to communicate more quickly with our clients, we have implemented a new system to provide e-mail updates as circumstances dictate. We will be implementing a blog later this quarter to provide an opportunity for more interactive communication for those who find that beneficial. In order to verify that we have your correct e-mail addresses, please send an e-mail to info@sfs.us listing the e-mail addresses where you would like to receive these communications. We will also be introducing additional technology and communication tools later this quarter.

As always, feel free to contact us at any time.

We appreciate your continued confidence in our services!

Wealth Dimensions Group, LTD

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