



## WEALTH DIMENSIONS

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In the second quarter, the markets experienced a welcome reversal following six consecutive negative quarters for the S&P 500. As economic data appeared to indicate a slowing deterioration, investors became more confident that an economic meltdown had been averted and the talk of green shoots once again raised interest in stocks. With the renewed optimism, the S&P 500 recovered its first quarter decline and, as of the end of the quarter, was up 3.16%<sup>1</sup> year to date.

### **The Derivative Market: Truth and Consequences**

As the economy and the markets continue to struggle to find equilibrium, it is natural for anxiety to rise and move us toward risk aversion. The events of the last year and a half have left us all frustrated with how quickly this broad deterioration occurred and many are anxious that perhaps it really is “different this time”.

We have discussed many components of this debacle in previous letters, including how this happened and the multiple contributing factors, who could've/should've seen it coming, etc. However, ground zero has to be the advent and explosive growth of derivatives. A derivative is an asset whose value is dependent on the price of another asset. For example, if I own a pool of mortgages and want to protect myself from a drop in value, I can negotiate with another party who will guarantee me the value of my mortgage pool in return for a negotiated payment, essentially financial risk insurance. This agreement forms the basis for a security which now has value. If the mortgages do not drop in value, the security is worth nothing. If the mortgages do experience a drop in value, the security goes up in value to protect against the decline in the value of the mortgages and I can collect from that other party (counterparty). In theory, I have now transferred the risk of the mortgages going down in value to the counterparty.

The plain and simple truth is that many of our financial institutions participated in this scheme and ultimately accepted way too much risk without receiving adequate compensation for that risk. In the end, there were derivatives on derivatives and then derivatives on those derivatives, allowing the risk to be sold and resold, thus multiplying it many times. In 2007, the total value of derivatives is estimated to have reached almost \$600 trillion, more than 10 times the value of all of the stock markets in the world combined with over \$2 trillion of derivatives

trading daily. The counterparties, like AIG, Lehman Brothers, Bear Stearns, Citigroup, Merrill Lynch, etc., were willing to take on this enormous risk because of its perceived profitability.

To put it another way, this could be likened to an insurance company insuring homes on a major fault line for a minimal premium. They then reinsure this risk exposure to another party who subsequently does the same and the cycle goes on and on. If an earthquake doesn't occur, all parties are booking profits (and paying huge bonuses). If an earthquake does occur, and if any link in the chain fails, everyone gets hurt. In the case of our financial institutions, the weakest link determined the strength of the whole chain and with the multiple levels of reinsurance, no one really knew who was in the chain.

The notion that risk could be transferred through the use of derivative financial products led to the boom in the housing market with credit readily available to high risk borrowers and also to the massive use of leverage within financial institutions. Nowhere was this more evident than with Government Sponsored Enterprises, Fannie Mae and Freddie Mac, whose leverage was estimated to have reached 100 to 1! When it came time to pay the losses, the counterparties did not have the money to cover their exposure and the system came crashing down, leading us to where we are today.

Now that the damage has been done, no one wants to take responsibility for the outcome. Even the Government would have you believe that they were unaware of these dynamics and the growing risk to the economy and the markets. Testifying before Congress, Treasury Secretary Tim Geithner told lawmakers the U.S. economy stumbled last year partly because the power and risks of an explosive derivatives market blindsided the Government. In his congressional testimony, Geithner said the ease with which derivatives were bought and sold in an era of easy credit encouraged financial institutions and investors to take on too much risk.

We find his testimony laughable considering that in 2003, Geithner was President of the Federal Reserve Bank of New York at the same time Alan Greenspan made the following public comments demonstrating the Fed's knowledge of and enthusiasm for these financial instruments:

"The vast increase in the size of the over-the-counter derivatives markets is the result of the market finding them a very useful vehicle. And the question is, should these be regulated? Well, indeed, for the United States, they are obviously regulated to the extent that banks, being the crucial creators of these derivatives, are regulated by the banking agencies, but not beyond that. And the reason why we think it would be a mistake to go beyond that degree of regulation is that these derivative transactions are transactions amongst professionals. And the institutions which are involved have very considerable what we call "counterparty surveillance", where, for example, one major bank will know far more about its customer, whether it's a bank or something else, than we could conceivably know as regulators. In a sense, this counterparty surveillance has become the crucial element which has created stability in that particular system."

At that same time, Warren Buffet had this to say in his widely publicized 2003 Letter to Shareholders. The following is a summary:

The derivatives market has exploded in recent years, with investment banks selling billions of dollars worth of these investments to clients as a way to off-load or manage market risk. These highly complex financial instruments are time bombs and "financial weapons of mass destruction" that could harm not only their buyers and sellers, but the whole economic system. Derivatives generate reported earnings that are often wildly overstated and based on estimates whose inaccuracy may not be exposed for many years. This can result in nasty accounting errors; some of them spring from "honest" optimism while others are the result of "huge-scale fraud". The US energy market relied on derivatives trading for many of its deals and this subsequently resulted in the collapse of Enron.

We have always operated on the principle that risk and reward are closely related, but not everyone in the market, including the Federal Government, sufficiently respected this relationship. In order for someone to transfer risk and keep the return, another party would have to accept the risk and not get any return for doing it. This simply does not make sense. Unfortunately, in addition to owning these derivatives themselves, the investment banking community was blinded by short-term profits, causing them to create and market extremely lucrative securities built on these derivatives to others. The Government was well aware of the risks, but the leverage made possible by these complex financial instruments supported a political agenda of economic growth and the expansion of home ownership to "underserved" borrowers who were simply not creditworthy. This process began with the Community Reinvestment Act and the repeal of the Glass-Steagall Act in 1999, both of which enabled banks to take on substantial additional risks within the existing regulatory framework.

Regardless of whether they accept their share of responsibility for this mess, the Federal Reserve and the Government have been forced into massive fiscal and monetary stimulus to mitigate the implosion of this derivative bubble. The collapse of our financial institutions has resulted in real economic hardship on Main Street due to the unprecedented contraction in available credit, as banks have little money to lend while they try to repair their own balance sheets.

### **The Long and Winding Road**

While none of us can change the circumstances that landed us here, the most important factor in persevering is to successfully manage the fear and anxiety while taking practical steps to weather the storm. Just as investors become overly confident when times are good, during times of economic and financial distress, investors generally become overly risk averse. This typically occurs after asset prices have already fallen substantially where risk is greatly reduced and potential return is increased.

As we have always advised, a healthy appreciation for risk and reward dictates utilizing both fixed income and globally diversified equities in order to mitigate downside risk while maintaining upside potential. While no strategy will totally eliminate the systematic risk of owning equities, the proper balance of risk free and risk assets will substantially reduce the probability of an unrecoverable loss. At select points along the way, strategic rebalancing will accelerate the recovery of capital and set the stage for future gains.

History has shown that, just as we managed through the seemingly endless unfolding of the dot com bubble, this too shall pass. In today's environment, companies are reducing costs, eliminating unprofitable businesses, and strengthening their balance sheets. Meanwhile, consumers are doing the same by reducing debt at record pace, increasing savings, and cutting out unnecessary expenses. At some point, all of these dynamics will shift the pendulum and we will have the beginning of a new positive economic cycle.

We all share the concern for the markets, the economy, and our country, but this concern can be eased with the knowledge of our rich history of facing adversity only to become stronger than ever. We have every confidence that we will see through this challenging time as well.

As you know, we have been unveiling a number of new communication tools to keep you informed on relevant financial matters and our most current thoughts. If we haven't done so already, we will be contacting you to discuss the current environment and its impact on your personal financial situation. As always, if you have had a change of circumstance that you feel requires immediate review, please contact us. Our highest priority is helping you achieve what matters most.

Thank you for your continued confidence in our services.

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<sup>1</sup>[www.standardandpoors.com](http://www.standardandpoors.com)

Investment indices are represented by the Dow Jones Industrial Average, S&P 500, S&P Midcap 400, Nasdaq, EAFE, and Nareit. Performance of these indices is not indicative of any particular investment. The indices are unmanaged and individuals cannot invest directly in any index. The Lehman Brothers U.S. Aggregate Bond Index is comprised of a variety of taxable bonds, and is used as a measure, or benchmark, of the US bond market. No strategy including diversification can guarantee a profit in a down market. Past performance does not guarantee future results.