MICHAEL COLEMAN, PH.D.
Registered Investment Advisor
RETIREMENT INCOME SPECIALIST

2124 Main St., Suite 170
Huntington Beach, CA 92648
Tel 714.960.2316
800.660.8727
Fax 714.960.0589
mdcoleman@unitedplanners.com
www.michaelcolemanphd.com

Now is The Time for Defense

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Dear Client,

We have long been wondering when the Real Estate Bubble would burst, and how it might affect our investments. The extreme market turbulence in August gave us our first taste of what a downturn in housing markets can do to the financial markets. Many commentators still expect this housing downturn to be short-lived. However, we believe the wave of losses in August is the first of a multi-year tsunami of real estate foreclosures and losses, and we expect considerable collateral damage throughout our economy. Every past financial Bubble that I have lived through or read about (anyone remember Dot-Com 2000?) ended with widespread financial pain. Why would we expect this one to be different? In my judgment, this past quarter marks a tipping point in the balance between risk and reward in the financial markets. The risk of a cyclical down market is now much greater than before.

Beginning in August we saw a number of Hedge Funds go broke overnight. Others like Goldman Sachs had to be bailed out by the infusion of billions of dollars. We saw a near failure of a German bank, the freeze of a French bank, and extreme daily volatility of 300 points either up or down on the DOW. We saw dozens of lending institutions in the U.S. go broke. So far 161 lending institutions have gone bankrupt since 2006.[1] On September 15, while I was in England, I witnessed a run on a fully solvent bank, Northern Rock, simply because its depositors feared that it "looked like" Countrywide Bank in the U.S. This started runs on two other banks that "looked like" Northern Rock. To stem a banking panic, the Bank of England agreed to guarantee all of the deposits of all of the banks in England! What do all these problems have in common? They were all caused by problems in the U.S. mortgage markets! Is this enough of a warning that further real estate losses may lead to unpredictable damage elsewhere?

Here is a well-publicized fact: "The Federal Deposit Insurance Corp. estimates that 2.5 million mortgages given to borrowers with weak credit will reset at higher rates and sometimes dramatically higher monthly payments by the end of next year."[2] How many of these borrowers will be unable to make higher payments, and will be forced to walk away in foreclosure?

"According to a study by Credit Suisse, nearly half of ***all*** U.S. mortgages originated in 2006 to finance a home purchase – not just those to sub-prime borrowers – were loans with little or no credit documentation, so-called 'no-doc' or 'low doc' loans."[3] Among people on the inside, these are known more affectionately as "liar loans."

Bernard Baruch, one of the great investors in the early history of the stock market, thought it was most important to recognize when there is "a change in the continuity of thought." I believe our real estate market has undergone such a change. Does anyone believe that prices for real estate will be higher next year? If housing prices continue to drop, few borrowers will have the collateral to refinance. How many of 2.5 million borrowers of dubious credit might be unable to make higher payments? Over the next year I think we will have a steady drumbeat of losses and foreclosures unlike any we have seen in previous real estate recessions. My concern is that these foreclosures might negatively affect the general economy in a manner that could bring sudden and unpredictable panics to stock markets worldwide.

Conclusion: Go Defensive and Wait

When Britain's South Sea Island bubble burst in 1720, Sir Isaac Newton lost a personal fortune of 20,000 pounds sterling. In ruminating on his loss, he observed that he could "calculate the movement of the stars, but not the madness of men." In my judgment, the most important "madness" that he forgot to factor into his equation was his own. Let this be a lesson for us all.

For all of you who are nearing retirement, are in retirement, or consider yourself a conservative investor, I recommend considering a change in strategy until we can determine how great the market risk is from the continuing real estate implosion. For the next year or so, I am recommending changing your primary objective **to not lose significant money** in either a sharp or protracted downturn in the markets. In a market environment of increasing risk, this would require us to give up the potential to make significant money in our growth strategies in order to temporarily reallocate these investments to a more conservative posture.

There is one place the small investor has a unique advantage over the large institutions. Inside qualified retirement accounts, he/she can reallocate to a defensive posture without any expense and without any tax consequences. If I have not already had a phone appointment with you to analyze your portfolio with this sort of change in mind, please call me and schedule a half hour discussion at your earliest convenience. Call Bonnie or Kathleen at (800) 660-8727 to make a phone appointment.

I am well aware that no one can call the top of any market. Nor can I be sure I am correct with respect to the potential negative outcomes. As Yogi Berra said: "Nothing is harder to predict than the future." However, my professional judgment built on 23 years of watching the markets leads me to believe that the level of risk is high enough that we should at least consider additional defensive actions over and above the ones we have already built into your portfolio. It's like driving up a mountain road and seeing an out-of-control truck coming our way. Even though that truck might miss us, isn't it prudent to get off the road at least until the danger passes, even if doing so temporarily slows our progress?

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[1] The Mortgage Lender Implode-O-Meter www.ml-implode.com
[2] Associated Press, Yahoo Finance, September 5, 2007
[3] Putnam Investments, "Capital Markets Outlook" 2nd Quarter, 2007