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Lessons from 2008
Strategies for 2009

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Warren Buffet once said, "You don't know who is swimming naked until the tide goes out." In 2008 when the financial system collapsed, we were all amazed to find out how many people and institutions were "swimming naked." When we look for the reasons for the difficulties, we find they are many. A world banker said the causes were "massive regulatory failure, massive supervisory failure, and massive corporate governance failures."[1] In this letter I want to review the theories and strategies of our investment world. Who are the losers and the winners in these extreme economic times? What should we learn from them? How do we need to adjust our investment strategies going forward? In the latter part of this letter, I will introduce you to a new service I will be rolling out to potentially provide you with even better protection during turbulent times.

In light of current market tumult, I believe existing financial philosophies may need to be reconsidered.

Free Market Ideology

In my opinion, free market ideology needs to be severely revised. Here are a few of the key ideas that I feel have been proved dramatically wrong:[2]

1. **Less regulation by governments is always better**. A market cannot actually be "free" without the <u>proper</u> regulation by governments. Crooks, fools, and knaves abound in a financial market without proper and continuous government regulation.
2. **Financial markets correct themselves by the "invisible hand" of self-interest.** Actually the history of capitalism is a history of booms and busts. In the long run markets have never adequately corrected themselves.
3. **Corporate executives can be trusted to not engage in excessive risk.** In his recent *mea culpa* before Congress on October 23, 2008, former Fed Chairman Alan Greenspan was amazed that the "self-interest" of the organizations that he refused to regulate did not protect "their own shareholders." I view this like putting the fox in charge of the hen house and then being amazed that the fox ate all the hens right now. Shouldn't foxes realize it is in their self-interest to save some hens for the future?
4. **Governments should not intervene when financial bubbles begin to form.** In December 2006, Alan Greenspan gave his famous speech where he expressed his

concerns about "irrational exuberance" in the stock markets. However, in that same speech he also explicitly refused to intervene, stating, "We as central bankers need not be concerned if a collapsing financial bubble does not threaten to impair the real economy, its production, jobs and price stability."[3]

The Efficient Market Hypothesis

In the financial planning world, I think it is now time to seriously question a number of commonly held accepted "truths."

1. **Buy and hold is the best strategy for investing in stocks.** When severe market corrections occur, some investors may benefit from not "buying and holding."
2. **Asset Allocation can protect us from extreme market volatility.** What we find is that during normal market conditions, a proper asset allocation does reduce volatility. However, during extreme market conditions all asset classes can collapse at the same time.
3. **We can expect to earn 10% or more over any 10 year period in a diversified portfolio of stocks.** The S&P 500, over the past 10 year period, has lost an average of -1.38% per year as of the end of 2008. If you invested $100,000 in the S&P 500 ten years ago and didn't take any withdrawals, your account would now be worth $87,026. If you were retired and taking income at rate of $5,000 a year, you would now be looking for employment.
4. **Nobody can time the markets, so we shouldn't even try to adapt our portfolios based on our judgment of risk.** Inside of many qualified accounts there are no costs or tax consequences when we reallocate our investments to more defensive allocations.

Tactical Allocation

In 2005 I warned all of you about the dangerous real estate bubble that was forming.[4] In August, 2007, I saw strong evidence that the housing bubble had begun its collapse. Since all prior financial bubbles that I have witnessed or read about had unpredictable collateral damage I decided in August,2007, that I would begin recommending that clients move all of their qualified assets to either cash or the most defensive portfolio available to lessen or avoid potential losses in 2008. We completed these moves by the end of October, 2007.

Strategies for 2009 and a new service

I expect 2009 to be a challenging year to make money, and I recommend that we begin the year with the goal of not losing money rather than trying to time the bottom of the market. At the same time, extraordinary times require new strategies, so I will soon be offering a new "elite" service at no extra cost to all existing clients.

From time to time I want to be able to take quick action to change your allocations to reduce volatility, and also to take advantage of investment opportunities when they present themselves. I cannot effectively do this if I have to make hundreds of phone calls and take two and a half months before I can take protective action. I am working on a simple contract that would give me the authority to execute my decisions quickly on your behalf for no additional cost. I intend to use this authority sparingly, and only when I perceive the risks to be high, or an opportunity to be compelling and comparably less risky. Giving me this authority will be voluntary on your part. As soon as I get the agreement finalized you all will be offered this new service.

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[1] *Wall Street Journal*, January 30, 2009. Angel Gurria, the Secretary General of the Organization for Economic Development and Development.
[2] Robert J. Shiller, *Irrational Exuberance, Second Edition*, 2005.
[3] *Ibid.*
[4] *Coleman Report October 2005*. "Protect Yourself Now from the Coming Collapse of The Housing Bubble."