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THESE NOT-SO-UNPRECEDENTED TIMES

One can't help to think that the current financial crisis and its economic repercussions are unprecedented when so many researchers, journalists, and television commentators now characterize most any development as unprecedented. In January, there were roughly 4,000 reports or articles describing some economic news as "unprecedented." With this unrelenting clamor, how can one resist the fear and panic? Clearly, "unprecedented" and its equivalents have been overused; and we wanted to demonstrate that fact with logic, reason, and knocking off a few cobwebs from events in the not-too-distant financial past.

Of course, the use of such terms as "unprecedented" make for appealing press, much of what we have experienced in the last year or so has, in fact, occurred *with* precedence in the past few decades. Specifically, the level of market volatility, the "seizing" of capital markets, the rapid and sizable devaluing in equities, the hit to high quality corporate bonds, the complexity of mortgage-backed derivative securities, the fall of several Wall Street firms, the drop in GDP—just to get started.

Let's start with the genesis of this current economic cycle: easy credit to the residential and commercial real estate markets and the subsequent carving up of mortgage-backed securities. These mortgages were packaged into bonds that led to the blow-up of several mortgage-based hedge funds. Such complex derivatives, also led to significant problems in the money market sector. From The New York Times: "Derivatives are complex securities whose returns are based on—or derived from—other investments. In this case, these derivatives started life as everyday home mortgages.... But in Wall Street's derivative laboratories, they are diced and sliced and reassembled into what can turn out to be a Frankenstein's monster." Old news you surmise?

Actually, it's *really* old news since we're referring to an article and events from the year 1994. In that same year one money market fund after another was kept whole by sizable capital infusions from their sponsors. In 1994, Bank of America injected \$67.9 million into its funds, and PaineWebber spent over \$268 million on its short-term funds. Others with smaller infusions included Merrill Lynch, First Boston, Piper Jaffray, and Fleet Financial.

Creative mortgages are not unprecedented either. In fact, date back to the mid-1880s when various railroad companies enticed settlers to Kansas, Nebraska, and the Dakota Territory by offering a menu of mortgages including, for example, an 11-year mortgage with interest only for the first three years and only 10% down. Sound familiar? Such easy credit led to a peak in land prices in 1887; in real dollars, those prices are still 5.5 times higher than the price of farmland in the region today after 110 years.

This is not the first time that mortgage derivatives, hedge fund debacles, or the bursting of a credit bubble have taken down major financial institutions....nor do we suspect it will be the last time.

The easy credit of the 2004 – 2007 period and the subsequent global boom in real estate,

as well as in public and private equities, emerging markets, and commodities, among others, is reminiscent of the easy credit of the mid-to-late 1980s that led to the savings and loan crisis with somewhat similar repercussions. Several banks and insurance companies were brought to their knees in 1990 and 1991, and investors were debating which banks were too big to fail. At the time, Citicorp, the predecessor to Citigroup, was at the top of the list of banks that were deemed “too big to fail.” In late 1991, Citicorp’s share price hit a trough of \$8.50, which in split-adjusted equivalent shares, is a mere \$0.93. In August 1990, the *American Banker* reported that the then-director of the Cato Institute suggested that “you have to sit the Fed and the Treasury and the FDIC down and say, ‘How do we deal with a Citi or Manufacturers Hanover failure? You have to have a plan in place.’ Well, 18 years later in November 2008, the Fed, the Treasury, and the FDIC did put a plan in place to avert a crisis at Citigroup. The parallels are blatant.

What about the unprecedented collapse of several Wall Street firms and the merger or acquisition of financial institutions such as Lehman Brothers, Bear Stearns, Merrill Lynch, Wachovia, and Washington Mutual? This is not the first time that mortgage derivatives, hedge fund debacles, or the bursting of a credit bubble have taken down major financial institutions. Where are the likes of Kidder Peabody, Manufacturers Hanover, Bank of New England, First Executive Corp, MCorp, Financial Corp of America, and Drexel Burnham Lambert? Financial Corp of America ran the largest savings and loan operation in the US. At its height, Drexel was the fifth largest investment bank in the US and had a 75% share of the high yield bond market. At the time of its demise, high yield securities were not only referred to as junk bonds but as “toxic” waste. So yes, not even the ever popular buzz-word “toxic” asset isn’t unprecedented.

What about the “unprecedented” seizing up or freezing of credit markets? During the 1973 – 74 period, the credit markets fared much worse. While recent spreads between borrowing rates and savings rates (the incremental yield between 3-month Libor and 3-month Treasury bills, which peaked at 4.64% on October 10, 2008), are certainly wide, these spreads pale in comparison to 1974 levels. After the Arab Oil Embargo of October 1973, the afore mentioned spread reached 6.22% and stayed above 5% for four months in 1974.

In the 1973 – 4 periods, the US economy had a cumulative decline in GDP of 2.7 percentage points, equities dropped 48%, and unemployment increased from a low of 4.6% to 9%. Interestingly enough, unemployment troughed at 4.4% in our current cycle, and is expected to peak around 8.5 – 9.5%. But to really compare the current crisis to the early 1970s, you may want to envision cars lined up at gasoline stations, big “no gas” signs plastered over hundreds of gasoline stations, and depending on the state you lived in, having to check your license plate because motorists with even-numbered license plates were allowed to buy gas only on even-numbered dates and those with odd-numbered plates were allowed to buy gas only on odd-numbered dates. Now that was unprecedented!

Federal Reserve concerns about the seizing up of the commercial paper market (the short-term source of funding typically used by mid- and large-sized companies) are also not without precedent. It is well known that Federal Reserve Chairman Ben Bernanke is a student of the bear market cycles; but judging by his recent actions, he must have also studied the commercial paper crisis and eventual bankruptcy of Penn Central Transportation Co. in 1970.

At the time, Penn Central was the largest transportation company in the world and a major issuer of commercial paper. As Penn Central’s financial condition deteriorated, there was an appeal to the federal government. The Nixon Administration was supportive. Congress, however, opposed a \$200 million loan guarantee (they didn’t call it a bailout then) and the Federal Reserve Board denied a loan to help Penn Central roll over the firm’s commercial paper. On June 21, 1970, Penn Central declared bankruptcy, which, at the time, became the largest bankruptcy in US corporate history.

To prevent widespread fear and panic in the markets and the consequences of further failures in 1970, the Federal Reserve, under the chairmanship of Arthur Burns, announced four measures:

- (1) It explicitly allowed member banks to go to the discount window to borrow funds for the purpose of helping clients roll over their maturing commercial paper.
- (2) It suspended ceilings on interest rates on large-denomination CDs to encourage the flow of funds into commercial banks.
- (3) It expanded its balance sheet to increase the money supply.
- (4) It committed that it would use standby procedures if necessary to make loans, directly or indirectly, to worthy borrowers who were otherwise unable to secure credit.

Again, the parallels to the liquidity measures undertaken by the current Federal Reserve are palpable. In July 1970, *Time Magazine* wrote: “The nation’s largest railroad succumbed last week to a lethal combination of politics, tight money, mismanagement, and fumbled Government rescue.” This sounds like some recent press coverage about Lehman Brothers, now the largest bankruptcy in US corporate history.

For those who are so thoughtless as to proclaim the death of American capitalism, the impending end of the US dollar as the reserve currency of the world, and the end of the American century, we offer the paragraph below. It appeared in *The Economist* in 1908 following the panic and crash of 1907, courtesy of Jim Grant’s book, *Money of the Mind*:

Public credit really depends on public confidence, just as private credit depends on private confidence. The financial crisis in America is really a moral crisis, caused by the series of proofs which the American public has received that the leading financiers who control banks, trust companies and industrial corporations are often imprudent, and not seldom dishonest. They have mismanaged trust funds and used them freely for speculative purposes. Hence the alarm of depositors, and a general collapse of credit.

Nearly 100 years later, in the December 16, 2008 issue of *The New York Times*, Thomas Friedman wrote: “we don’t just need a financial bailout; we need an ethical bailout.”

What *is* unprecedented today is the scale and speed of monetary policy response by the Federal Reserve. Specifically, the nearly simultaneous implementation of a zero to 0.25% interest rate policy, 12 different liquidity facilities, and the expansion of the Federal Reserve balance sheet to about \$2.3 trillion. Moreover, the planned government action in the coming months via a public-private partnership that will help banks remove troubled assets clogging their balance sheets is certainly without precedent.

Our goal here has never been to minimize the depth or breadth of the current economic cycle. While serious challenges remain and uncertainties abound, much of what we see in the market environment is not unprecedented. We have experienced wild swings of panic and greed before, and we are certain to see it again.

Source: Sharmin Mossavar-Rahmani, Goldman Sachs, January 2009.

Stock Pickers, Astrologers, and False Prophets

Every January, *USA Today* asks the “best minds” in the financial services industry for their thoughts on how the S&P 500 will do. As you can see from the chart below, those predictions didn’t fare so well in 2008.

2008 Predictions For The S&P 500 Index Year-End Value

Supposed “Experts”	Prediction for the S&P 500 at year’s end
Abhijit Chakrabortti (Morgan Stanley)	1520
Richard Bernstein (Merrill Lynch)	1525
Stuart Freeman (A.G. Edwards)	1575
Rod Smyth (Wachovia Securities)	1590
Thomas Lee (JP Morgan Chase)	1590
Tom McManus (Bank of America Securities)	1625
Abby Joseph Cohen (Goldman Sachs)	1675
Tobias Levkovich (Citigroup)	1675
Jason Trennert (Strategas Research Partners)	1680

Source: USA Today. 2008 predictions for the S&P 500. January 2, 2008.

To give you an idea of their **gross lack of forecasting acumen**, the S&P 500 began 2008 at **1468** and ended at **885**.

2008 was an certainly an unusual year, but if these expert strategists can't even get the ballpark performance—or even direction—of a single index right, it is difficult to see how they can possibly build great portfolios. Further confirmation of the limitations of active management is offered by the stock picking prowess of some of these experts. *USA Today* asked five of them to **select their top 5 stocks** for 2008. These top picks from some of the most experienced prognosticators on Wall Street returned **-44%** in 2008—easily outpaced by the S&P 500's -37%.

With this kind of record of accomplishment, we should not even care what these experts foresee for 2009. Flipping a coin might be more accurate. Alternatively, perhaps we can just forgo any semblance of logic and turn astrology. The following forecast is so crazy we couldn't even possibly be making this up:

“Looking ahead, one of the next big crash dates could possibly be Black Friday, August 14, 2009. Here are the reasons, in order of importance. (1) Saturn within orb of opposing Uranus (2) Lunar node in Aquarius (3) Sun opposing Jupiter and Neptune (4) Mars squaring Uranus.”

Source: www.luckydays.tv/stock_markets.html

While markets may appear chaotic and unpredictable in the short-term, over the long-term they are remarkably efficient and almost impossible to beat with schemes of timing and stock selection. You already know that instead of listening to stock-pickers' advice, it is much more prudent to follow a diversified, structured approach.

LESSONS FROM THE PAST FEW MONTHS...

- Poorly advised investors were rudely reminded of the nature of single stock risk. Holding concentrated positions of AIG, GE, Citigroup, GM etc., was disastrous for investors who associated great big companies with less risk. This is a mindset indicative of classic Wall Street broker mentality that a portfolio of 25 large us stocks means you are well diversified because he or she will pick the right 25 stocks. We happen to think owning 10,000+ stocks in 40 countries means you are well diversified.
- If a Wall Street firm cannot manage its own finances, investors should not trust them to manage theirs. It amazes us that Merrill Lynch, Wachovia Wealth Management, Morgan Stanley, and similar firms have any clients left at all.
- Bernie Madoff reminded us that if returns seem too good to be true—they probably are.
- Contrary to how they are marketed, hedge funds do not perform well in both up and down markets. In fact, in 2008 we saw over 900 hedge funds close their doors—over 12% of the total hedge fund market (and that doesn't count the ones that raised capital and never got off the ground). That money vaporized...it won't recover with the market because it's gone.
- The inclusion of the fixed income asset class is to dampen volatility in a portfolio, not chasing yield. High-yield bonds lost over 28% in 2008...hence the reason they are not included in a prudent portfolio.
- Companies can and should fail from time to time. These failures are like a giant tree that crashes down in a dense woodland allowing light to finally reach the forest floor. Other trees will soon race skyward to replace it. When the Dow Jones Industrial Index was formed in the late 1920's, like today, there were 30 companies listed in the index. Only three of those original companies still appear in the index today. The other 27 fallen giants have made room for hundreds upon hundreds of other companies to prosper. Investors who are globally diversified into small and large companies have benefited from their ascendancy. Investors who think their financial livelihood is inexorably linked to the fate of a handful of behemoth US corporations will spend sleepless nights worrying in the absence of any good reason.