

# The Continuing Market Saga

## *The Financial Crisis, Diversification, The Media, and Long-Term Returns*

The financial markets have been pretty frustrating and scary lately. Housing, real estate, and mortgages continue to trouble markets, and the S&P 500 Index has fallen 26% from its peak in October 2007 (as of September 17). Foreign markets are down even more. Once admired "gold standard" companies like Bear Stearns, Lehman Brothers, and Merrill Lynch have gone the way of the dinosaur. Furthermore, the futures of AIG, Washington Mutual, and even Morgan Stanley are uncertain. Wall Street took too much speculative risk to maximize profits, lost the bet, and is now scrambling to fix things. Fortunately, Savant clients have always held broadly and globally diversified portfolios and are not overexposed to any single company or sector.

### How Do Recent Events Affect You?

Earlier this month, the U.S. Treasury announced a government takeover of Fannie Mae and Freddie Mac in order to stabilize the mortgage market. The biggest exposure that Savant portfolios have to Fannie and Freddie (around 4% of a typical 70/30 portfolio) is via mortgage-backed securities that the two companies guarantee. These bonds hold pools of normal (not sub-prime) or conforming mortgages – if you have a mortgage on your house, chances are good that your mortgage is actually held by these Fannie or Freddie bonds. The first thing to remember about these bonds is that the repayment is primarily based on the individual mortgages that make up the pool for each bond. As long as the mortgages in the pool are paid each month, there is no problem. If one of the mortgages in the pool defaults, Fannie and Freddie take that mortgage out of the pool, so the bondholder is not affected – the risk to the bondholder is almost non-existent. Nevertheless, the market had priced in some risk since it was unclear how the government would act to back the two companies. Now that this uncertainty is gone, the markets responded very positively. These bonds are now, in a sense, backed by the Treasury.

Savant index fund portfolios also have very small allocations to bonds and stock issued by Fannie and Freddie. The government plan is good news for the bonds, since these bonds are now explicitly backed by the U.S. government. Of course Fannie and Freddie stock is now almost worthless, but since Savant index portfolios have such a small allocation to Fannie and Freddie stock (less than 0.1% in a typical 70/30 portfolio), you were not really affected – diversification works!

The latest news about Lehman Brothers has also unsettled the markets. All of the top players in Wall Street gathered over the weekend to come up with a plan that might save Lehman

Brothers, which is struggling with failing sub-prime mortgage investments. However, the U.S. Treasury decided not to step in and support a deal as it did earlier this year with Bear Stearns. As a result, no deal was made, and Lehman Brothers was forced to declare Chapter 11 bankruptcy. Like Fannie and Freddie, Savant portfolios have a very small allocation to Lehman Brothers stock (less than 0.1% in a typical 70/30 portfolio). Once again, diversification protected your portfolio, and the failure of one company did not have a disastrous effect.

As gold standards like Merrill and Lehman have met their demise, some Savant clients have asked if our custodians are safe. As you are aware, Savant clients primarily custody their money at either TD Ameritrade, Charles Schwab, or Fidelity. We believe that the custodians Savant uses to facilitate trading in your account are not in any danger, and your money is safe. Companies that got into trouble (like Lehman) took a lot of risk by heavily investing their own money, as well as a lot of borrowed money, in real estate and mortgages. Savant's custodians have a very different business model. They rely on brokerage commissions, advisory fees, and asset management for their income. They have almost non-existent exposure to the speculative investments that are at the root of the market's current troubles. In addition, Savant's custodians are members of the Securities Investor Protection Corporation (SIPC) and also have additional insurance to protect the assets in your account in the unlikely event of insolvency. Each investor account is thus protected up to in excess of 100 million dollars. So while the market may be frustratingly volatile right now, we believe that your assets are safe.

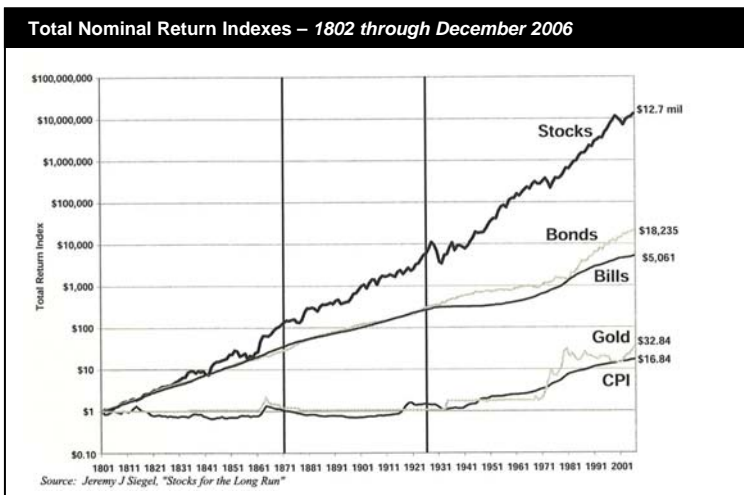


## It Is Not Different This Time

Although it has been a very frustrating year, we remain confident that things will eventually turn around. The problems faced by the financial industry are not a result of widespread economic weakness. The financial industry is struggling because of its own risk taking – the rest of the economy is mostly continuing with business as usual. Also, the Federal Reserve has instituted numerous mechanisms to improve liquidity (the central banks announced that they are injecting \$180 billion of liquidity into credit markets), and the leaders of the major financial companies in the U.S. have worked together to create an emergency liquidity fund that can be accessed in times of need. Oil prices have now fallen below \$100 per barrel, which should help to ease gasoline prices and inflation. The P/E (price to earnings) ratio of the S&P 500 is historically very low, suggesting that stocks are very cheap. Finally, fear has driven some investors into cash. As these investors regain confidence, these dollars could flow back into stocks and lead to gains.

Markets have survived situations like this before and have always recovered in the past – we believe it is not different this time. Financial crisis is nothing new. Historically, markets bear the brunt of a credit crisis every 7-10 years. This one might seem particularly scary since it is in the here and now, but much of the current decline is fear-driven – remember that the media exacerbates the situation. What we know for sure is that people will continue to borrow and lend money, companies will continue to use investment banks to raise capital, people still need insurance, and they still need to invest their savings. As such, while the financial sector is certainly exciting at the moment, things will settle down and return to normal – history has proven this over and over. In the meantime, your diversified portfolio will help protect you from the problems that affect any single company or sector of the economy.

Figure 1



## The Media Creates Anxiety

On the topic of the media, realize that the press is not in the business of making money for you but rather in the business of selling advertising. As such, it is their goal to keep you off balance by focusing on the day-to-day and even minute-to-minute market noise. This keeps you tuned in. This is the reality in the Internet age, but it is our job to keep you focused on the long-run. As such, we thought it timely to share with you an update of the history of stock markets. The chart below (Figure 1) is from the best-selling book "Stocks for the Long Run" by Jeremy J. Siegel. It shows that while stocks can decline during any given year (sometimes for several years), they have always recovered and remain the best way for investors to build wealth.

Lastly, the second chart below (Figure 2) shows how the market has reacted in the past to a variety of scary global events and financial crises. The message is clear – people and markets are resilient. Markets go up in spite of uncertainty and scary events.

Remember, we are on watch. We continue to monitor your portfolio and the markets. We are thinking of you even when you are not thinking of us. We promise to continue monitoring the situation and to be a proactive steward of your funds.

And, as always, please feel free to give us a call if you have questions or would like a little reassurance during these volatile markets.

*Savant*

Figure 2

