



MALLARD ALERT

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Market Meltdown?

Paul S. Baumbach

"Experience is a hard teacher because she gives the test first, the lesson afterwards." – Unknown

I generally begin my Market Alerts with this quote, for I write them at times of great market uncertainty (the most recent two followed Hurricane Katrina and September 11, 2001. During times like these, everything in our hearts call us to 'abandon ship'.

In past newsletter articles I covered the human brain's tendency to quickly make the 'fight or flee' decision, and to provide adrenaline to reward lightning decisions. Unfortunately, the human brain often is a burden to successful investing. **The human brain is designed to make us very successful lemmings**, as it gives us a shot of adrenaline when we join the stampede to jump off the cliff, and to sell into a falling market.

At the risk of drawing parallels between today's market crises and the Great Depression, I am reminded of Jimmy Stewart's line from one of my favorite movies, *It's a Wonderful Life*, when local businessman Potter tries to take over the Bailey Savings and Loan: "Don't you see what's happening? Potter isn't selling. Potter's buying! And why? Because we're panicky and he's not. That's why. He's picking up some bargains. Now, we can get through this thing all right. We've got to stick together, though. We've got to have faith in each other."

Where are We? US stocks are down about 12% year-to-date, and it looks like they will fall further today. Financial stocks are down even more (and are continuing to fall further). International stock funds are down almost as much, largely due to concerns that the US economic slowdown (recession), will result in a sharp drop in US consumer purchases of foreign goods, and thus the US economic slowdown will become contagious.

The US dollar has been falling in value all year, after having fallen in 2007. It is setting (bad) records. This is largely due to the Fed's efforts to head off a recession—the Fed's cuts to the discount rate make foreign bonds more attractive than US bonds, and thus global investors have stopped buying US treasuries, purchases which otherwise prop up the dollar. This is compounded by the fact that oil is priced in US dollars—a decline in the US dollar causes a rise in the price of oil, which weakens the US economy further. **It is a vicious circle.**

Which brings us to the subprime mortgage crisis. These loans were made in large numbers, to borrowers (both homeowners and speculators) who could only afford them if housing prices continued to rise to the sky. When housing prices stalled, the borrowers could no longer justify a low-rate refinance, and these loans became liabilities.

The firms which originated these loans sold them to other firms which packaged them up and sold them yet again. They changed hands so many times that the current holders have little ability to see which ones are solid and which aren't, and this means that it is very hard to assign a fair value to them.

This is aggravated by the bond rating firms which generally hardly scratched the surface before claiming that the pools of mortgages were triple-A (a rating that assumed that all was well in the housing world), and the bond insurance firms, which used their good name to back these pools of loans, the details of which were little understood, and the

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quality of which depended on a stable housing market—a market which no longer exists.

As this house of cards has come crashing down, the financial firms with loads of these loans on their books have been unable to find a fair value for them. In some cases, these pools of loans were used as collateral for bank loans, and the value of this collateral has disappeared, and the lenders are calling the loans. This caused Bear Stearns to wave a white flag last week, and agree this weekend to be taken over by JP Morgan, with the Fed's blessing.

The Fed has taken both customary and unusual steps to head off a recession in the past six months. Fortunately, they began with a lot of ammunition. Unfortunately, this ammunition is beginning to run low

What's Next? There are four strong positives on the horizon. The first, is that the market sees none of these positive factors—which means that when they are finally recognized, the market should rise. In sharp contrast to the environment from 1999 when investors saw only the positives, right now the market can only see the holes in the doughnuts. When investors recognize that there are some areas doing OK, and that the worst sectors will eventually come back, stocks can rebound, and sharply.

The second positive on the horizon is the Fed. They have been active for more than six months, and most Fed action takes six to nine months to have an impact. As such, we could be weeks away from the positive economic impact to last August's rate cuts.

The third positive is that Congress and the Administration put a pretty smart economic incentive program together very quickly, a program that is well-targeted to get \$150 billion quickly into the US economy.

The fourth positive is history of economic downturns. They typically last six to nine months, and the stock markets typically begin to recover ahead of the economic recovery. This all points to brighter days ahead for investors.

So What Do Investors Do? At the risk of sounding like a broken record, like a 'rose-colored

lenses' optimist, I recommend that you maintain your investment discipline. If in calmer times you determined that you should have 70% of your investments in stocks, then keep 70% of your investments, today, in stocks. Long-term allocation targets need to be maintained in good times, and even more importantly, in difficult times, such as we have today.

This is also the reason that I recommend that you write down your investment policy. This enables you to fight your 'lemmings tendency', the tendency to add money to a hot market, and to pull money out of a falling market. **These tendencies are strong, but are dangerous to follow.**

The US has gone through many, many crises, domestic and foreign, economic and societal. These have included two World Wars, a Great Depression, a Cold War, the Cuban Missile Crisis, the Vietnam War, the Oil Embargo, the 1987 Stock Market Crash, and 9/11. While a few investors got out early and saved some money, a far larger number of investors cashed out during the crisis (sealing in their losses) and were emotionally incapable of getting back into the market during its recovery, a recovery which invariably is not obvious until it is too late to get in at a low cost.

This is the reason that I believe deeply in being a broken record, that **I strongly advocate staying the course during stormy days (months, years).** This is the reason that I recommend buying stocks at times such as these, when stocks are down 10 or 15% in less than three months. For I believe that in twelve months the US economy will be well into its recovery, and the US and foreign stock markets will be well into their recoveries. Should this come to pass, investors will kick themselves for their March 2008 sales, and will smile when they consider their March 2008 purchases. **May it be so!**



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