MIKE CHADWICK'S

MONEY MATTERS

ADVISING, EDUCATING & INSPIRING YOU TO A BETTER LIFE

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Fear, Panic and Hysteria

This is the first time in years such absolute fear has taken hold of the investing public in general. This fear is typical of bear markets but this time it's grossly exaggerated. The dilemma we have in the world today is constantly compared to The Great Depression and every headline you see is overly dramatic – "meltdown" "bailout" "panic" "depression" "Wall Street failure" "crisis" etc. With that mentality prevailing, it's no wonder people are so concerned.

What has caused the current dilemma we face today and how do we fix it? The current problems with the financial markets were brought to a head with the real estate transactions of the past 5 – 10 years. Many homes were sold at values that were much higher than what the houses were actually worth and some people went with crazy financing options that were not affordable on a long term basis. Why did this happen? The government rules, policies and laws were the driver for the real estate fiasco. Since the 1970's laws have been on the books that make it mandatory for banks and financial firms to lend money to low income people or those with little chance of paying it back – all in the name of making real estate more affordable. The government created Fannie Mae (FNM) & Freddie Mac (FRE) to help people more easily afford a home. As we've been telling people for the past few years, not everyone should or can own a home and a home is not an investment, it's a place to live.

Once the homes were bought, most of the underlying mortgages were then sent on their way to become married to thousands of other mortgages and turned into securities – bonds called mortgage backed securities. These bonds typically carry a par value of $1,000 with a stated coupon interest rate – 6%, 7%, etc. The securitization process was thought to spread the risk of loans across the financial system and simultaneously enhance returns.

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INSIDE THIS ISSUE

Buying Businesses

Let's say you're looking to buy a local business and your target is Joe's Bar & Grill. Joe's been in business in town for 30 years and he has the best atmosphere and food around. Everyone goes there to eat and just hang out. Joe's tired and he's ready to sell. You and Joe struck a deal and you're buying the place for $600,000. Joe's average income for the past 7 years has been $200,000 per year so you're paying 3 times earnings for the business. That's not a bad deal and on a local level, businesses will sell for 3 times earnings. With this deal, you're buying the whole business, so you're the sole stockholder and own 100% of the outstanding shares of the company. You and Joe agreed on a price after having a professional appraiser appraise the company, and you trust the figure because you paid the appraiser $8,500 to do this job. The price of this business will change all of the time, but you're not going to get it appraised again until you go to sell.

When you buy stock of a public company like GE or IBM on Wall Street, you're buying a very small piece of a very large business, you're one of a million shareholders, and on average you pay 15 times earnings for that company. If Joe's Bar and Grill were a public company, on average he'd get 15 times his $200,000 income and sell the place for $3,000,0000, not $600,000 that you paid. This is why companies go public, the valuations are much higher since owners don't have to buy the whole company, have no management responsibility and can sell any portion at any time with complete liquidity. This publicly traded business that you bought on the stock exchange is appraised virtually every second of the day and changes from millisecond to millisecond.

The reality is businesses are priced based on income and using 15 times earnings as an average, if Joe's income goes up a lot so will the price of his business over time. If his income goes down a lot, so will the price of his business over time. Let's say over the next 5 years Joe earned on average $500,000 each year and it's still selling for 15 times earnings, now his company is worth $7,500,000 and he paid $3,000,000 – that's a killer return on investment. On the flipside, if his income goes down to $100,000 on average over the next five years now it's only worth $1,500,000 and that's a terrible return on investment. At the end of the day the business is always worth a certain amount based

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The old school of bank lending where the bank kept the loan was dismissed: very few firms do that anymore. This is a key break in the integrity of underwriting mortgages and now that people are scared, they simply don't trust these securities. The combination of bad loans, declining real estate market and slowing economy, over the next 5-7 years we expect around 6% of all mortgages will be either foreclosed or will be in a short sale. These mortgage backed securities will not likely be worth $1,000 over the long haul because the 6% in foreclosures is much higher than the anticipated 1-2%. Right now, because of pure fear in the marketplace, these securities are trading at values of $150 -$650, nowhere near the $1,000 par value they are supposedly worth. Since there are issues with the underlying loans, the securities should show a discount, maybe 5-6% and should sell for $940 - $950 each. The only way to justify current pricing of these securities is to have 35% - 85% of all mortgages in America go into foreclosure and each of the foreclosed homes would vanish worthless. Obviously that isn't going to happen, but that is how the market is pricing things because of the absolute fear and panic on the street today.

The lack of trading in these mortgage backed securities has spread like a disease and caused many other components of the bond market to dry up. Municipal bonds, corporate bonds and other forms of bond trading has slowed to a crawl and in some cases, stopped completely.

Short-term lending between businesses, commonly called commercial paper, is also struggling right now. Commercial paper is how large institutions get money over a short period of time, typically less than a year, from other institutions.

Let's say GE needed $1 billion cash to pay for supplies for a pending windmill installation projects. IBM may have that money sitting in a non-interest bearing checking account that they won't be needing in the coming year so they'll offer the money to GE for 9 months at 5%. This is a much more efficient way for companies to get and lend money rather than going through a bank. These firms also have billion dollar credit lines through banks, but it's cheaper to use the commercial paper markets to raise short-term capital.

There is nothing we need to do to "correct" today's ills. The mortgage industry is already a changed one. Loans that were prolific just a few weeks ago are no longer and we won't see them again in our lifetimes.

The main issue today is one of confidence, not economics. At some point again very soon, people will gain confidence in the system and begin lending to businesses and trading bonds with normal volume. The government's bank stimulus package is designed to provide the confidence that mortgage-backed securities will be bought from private companies, housed in a government facility, and then sold back to private companies in the future when things settle down.

At today's prices, the government stands to make trillions on this process, let's see how it unfolds. ☺

The Right Path

As markets have swung wildly in the past six weeks I've been asked countless times, should I choose a new path? This craziness is part of investing and although we haven't seen the extreme panic and terror that we've seen lately, this is a normal part of the investing process. Stocks are down 30% from their levels at the beginning of the year so we're going to have losses today. We've had small losses for the conservative accounts to losses almost equal to the markets for our aggressive accounts. This is nothing new in the investing process and although it's painful, the only way to win in the end is to stick with the original plan. Recessions happen, and we're not officially in one the government may say that we were after the fact, they're never declared before hand, always after the statistics have been compiled. Many people believe they can "time" the market and know just when to get in and just when to get out. That is a fallacy and studies have proven the only way to win with investments over the long-term is to stick with them during ups and downs. Look at the following study of the markets from 01/01/1981 to 12/30/2005, assuming you were invested in the S&P 500 Index.

Invested the entire time your return would have been	9.28%
Missed the 10 best days your return would have been	6.96%
Missed the 20 best days your return would have been	5.26%
Missed the 30 best days your return would have been	3.77%
Missed the 40 best days your return would have been	2.42%

Clearly the right path is to stick it out and eventually we'll come out ahead. The trick to this process is the best days are typically very close to the worst days, often back to back by days, weeks or months. We all know the past six weeks have been just full of worst days in a row and there is only so much bleeding that is possible. The markets are so oversold right now the best days should be close if not right upon us. Another consideration for us as emotion dictates maybe it makes sense to pull out now to stop the bleeding and go to cash or CD's – at least there we can be guaranteed to make 1-3%. I know that makes emotional sense but economically that's shooting yourself in the foot! Here is how the markets have performed just after a bear market, again as measured by the S&P 500 index. We've studied the bear markets going back 50 years and there have been 11 of them, including this one. A bear market is defined as a 20%+ decline in market averages and as of Oct 6th the S&P 500 is down 34.78%, clearly a painful bear attack! ☺ During the 3 months after a bear market, investments as measured by the S&P 500 are up, on average 15.8%. 6 months after a bear market, on average, they're up 21.4%. 9 months after the bear market, on average, they're up 32.2%. 1 year after the bear market, on average, they're up 32.4%. Think about this, would you prefer a guaranteed 1-3% return on a CD or a post bear market return of, on average 32.4% in the coming year? I'm sticking to what we originally planned - this is what it feels like to buy low so buy now! ☺

Noteworthy News! ! !

- Congratulations to Chris & Monica Russano on the birth of baby number one Natalie Mae! ☺
- Congratulations to John & Leslie Gordon on their recent marriage, the beginning of a beautiful life together.
- Congratulations to Bob Bourassa on the purchase of his new business Carriage House Farms and the start of his other new business, BB Custom Catering. Sleep will be coveted item in the near future! ☺
- Congratulations to Dan Albanese on the expansion of his business, Maletta Pfeiffer & Associates Physical Therapists opening their second office! ☺
- Congratulations to Ted & Tracy Michaud on their recent marriage, the beginning of a beautiful life together. ! ☺
- Congratulations to Lee Rho on the purchase of her new home! ☺

A Tribute to Sir John Templeton

Investment legend Sir John Templeton passed away on July 8th, 2008. He was 96 years old and provided a mind boggling amount of good to the investment and spiritual worlds. A true pioneer of value investing and one of the first to introduce globally diversified mutual funds, he's famous for many investing maxims. He says that when you invest for value you need to know the difference between price and value. If a value presents itself and a business can be purchased for a price on the stock market that is much less than it's true value, it's a winning situation. He's also famous for some of the best investing quotes ever: here are just a few:

- The four most dangerous words in investing are "This time it's different"
- The time of maximum pessimism is the best time to buy…and the time of maximum optimism is the best time to sell. (he is now saying, from the grave, we are currently at one such point of maximum pessimism ☺)
- Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria.

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on the income that business will generate, period. Over time, there will be mass fluctuation in the value of the business, none of which is based on long-term economics but short term news and emotions, but the long-term earnings will drive the long-term value, period.

Now let's think about this in terms of what's happening today with the seeming economic meltdown. We know there are issues with homes, home prices and some mortgages and financial firms that were too heavily involved in such transactions. Bond markets are lacking in transactions and need lubrication, people are fearful if not downright terrified. Businesses continue to make money, some are making less than last year and some are making a lot more. For those making less, if that trend continues those businesses will be worth less in the coming years unless the trend changes. For the businesses making more money, those enterprises will be worth more in years to come because with higher earnings comes a higher price of the business. In the past four weeks almost 20% of the market value of virtually everything has gone down, regardless of what individual companies earnings are doing. That makes no sense if the firms are not being hurt by the currently distressed debt markets. For firms that have nothing to do with finance or mortgages who are declaring earnings increases of 20+% and buying back their own stock, this makes absolutely no economic sense whatsoever.

As a student of investing I've read about this disconnect phenomenon many times but now I'm seeing it for the first time in real life to a massive degree. The disconnect is happening today between the value of a business as displayed on Wall Street and what you can buy it for today versus the true value of the enterprise based on it's ability to earn money over time. These two numbers are very different things and can be capitalized on today in a big way. We have a disconnect today between the prices of businesses that you can buy on Wall Street and their actual value, this disconnect represents the biggest value I've ever seen and equals what I've read about being capitalized on decades before by people such as Charlie Munger, Warren Buffet and Benjamin Graham.

There are times when prices do get out of control and the price people pay for a business goes way beyond $15 for $1.00 of corporate earnings – during the late 1990's and early 2000 dot com bonanza many firms were trading at 200 times earnings. Today valuations are fair to cheap, not grossly overvalued as they have been in the past.

Now is the time to be a buyer of businesses when you can get a serious discount on them. ☺

Money Quiz

Congratulations to Franco Masini on winning last month's quiz. The average inflation outside the USA for the past decade has been 7%. ☺

This month's challenge is to tell me what percentage of workers age between age 58 & 62 are employed by the same employer as when they were 50. The winner will have lunch on us at Chili's. ☺

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No More Shorts

Short selling (profiting as stocks go down) as we knew it is gone for a while – the SEC has banned short selling now and has extended it a few times to try and stop the manipulation we likely have of the markets by hedge funds who don't disclose their trades in financial firms. The count is now about 1000 firms who are safe from short sellers, for a while. Countless countries around the world have all done the same thing, in an attempt to thwart off crooks who try to make businesses fail by short selling them and creating panic in the streets.

Short selling is not a bad thing, but over the years many of the stop gaps that have been in placed were removed by government regulators. I cannot fathom why they did this, but they're paying for it now and I expect the uptick rule to come back. The uptick rule is one that says you cannot short a stock until is has gone up at least one tick, which translates into a penny. Now if a stock is falling you can just keep shorting it and shorting it, and it's an evil downward spiral – more pressure down on a stock can sometimes kill it. The uptick rule will stop that from happening and will help in restoring an orderly trading system where the government won't have to ban short selling from time to time.

Even with a short selling ban, there are still ways to profit from a dropping stock price: options will allow the same type of profits as will leveraged mutual funds that use options to accomplish the same objectives. Options can have direct impact on the companies which have listed options but by acting through a mutual fund or exchange traded fund it can only be industry specific, not company specific. Since winter is coming, put the shorts away and get the long johns out! ☺☺☺

Draconian Accounting

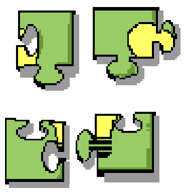
Most people think of accountants as really smart people – and for the most part they are. As I've spoken about these "mark to market" accounting rules I've decided to give you a comparison with your home and mortgage to better understand what's going on with the global financial fiasco. Today's mortgage security prices have absolutely no relationship to economic reality. Since the accounting rules drive this, it's forced the government to come up with draconian solutions to issues that shouldn't exist. Here is how the mark to market accounting works.

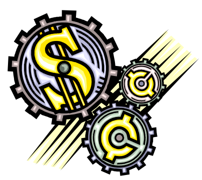
Let's say you have a house worth $300,000 with a $200,000 mortgage and you're staying in this house for 20 years. Your neighbor just lost his job and he needs to sell his house today, but because the market is tight he can't get $300,000 so he sells for $150,000 just to get out today. If your bank had mark to market accounting rules, the new market value of your home would force you to give the bank $80,000 today so you'd have 20% down and your house is now worth $150,000. If you didn't give your bank the $80,000 today you'd lose your house. Does this reflect economic reality? Not at all. If you're selling an asset today, mark to market accounting makes sense, but if you're holding long, your asset is worth what it's worth when it matures, not what the last one just sold for when there is virtually no market for it. With real estate locally, when a property sells for a "low" value, it becomes the new comparable which all other properties in the area will be compared to for sales that are forthcoming, so it will drive prices down over the next few months and years. 20 years from now, when a house is sold or a security matures, it'll be worth more than it is today, even if during the interim there is a sharp downward price in the value of the asset.

This silliness with accounting is what corporate America and the corporate world in general is struggling with as every time an asset sells for less than what it's marked on a companies balance sheet, they immediately need to mark it down and come up with money to satisfy capital ratio requirements. This is an evil downward spiral because so many of these assets are held globally nobody is insulated from the disease. This is how firms are falling down today – Merrill Lynch was forced to sell $30.6 Billion of mortgage securities for $6.7 Billion, just 20 cents on the dollar, to Lone Star Funds because of accounting rules. Firms that are truly unhealthy need to fall – Washington Mutual bank couldn't survive, most of it's loans were bad where most banks have a vast minority of loans that are bad, 5-6%. Expect drastically different financial rules in the coming years – banks, mortgage companies, corporations and consumers will have to adjust to a new set of rules that won't allow for such manipulation and punitive destruction. ☺

Inspirational Quotes

- The less you know, the more you believe, *Bono*
- The real problem is not whether machines think but whether men do, *B.F. Skinner*
- I am certain there is too much certainty in the world, *Michael Crichton*
- Freedom of the press is only guaranteed to those who own one, *A.J. Leibling*
- Happiness is like a kiss, you must share it to enjoy it, *Bernard Meltzer*





We can piece the puzzle together and make your money work for you. ☺

Kids Korner

The use of the internet is huge for our youth today. You not only have to watch the kids and what they see on the web, you must watch what they publish on the web, since it may include you! Make sure your kids are very careful about what they put on the web, especially for self publishing such as www.facebook.com and www.youtube.com. These sites allow anyone to post videos and movies about any topic, off color or not. Once this information is published, anyone can get it, store it and keep it to later be redisplayed for the whole world to view. If the kids put something online that they may later regret in life, it could hurt their ability to get a job or otherwise influence their future adversely. Watch what the rugrats are doing on the web! ☺ ☺ ☺

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