



## 2008 – 3RD QUARTER REVIEW AND PREVIEW



### BOB'S CORNER

As you can see on page four, this has happened before. We all need to stay as unemotional as possible! In preparation for a downturn we started taking chips off the table way back in November of 2006, then again in August of 2007, and until panic created a downward spiral of all asset classes in the last three months, we were significantly out-performing the market on an absolute and risk adjusted basis.

Please read the enclosed letter that helps explain what we have done, where we are at today, and why, with patience, we will again see the market go up!

I also want to thank everyone who has called and asked great questions and given us the chance to help you stay focused on your long term goals. We are here to answer any and all questions.

### Special Seminars

#### “Panic Is Not An Investment Strategy”

Straight answers for high net worth investors facing a volatile market. These seminars are being held every Tuesday at 7:00 p.m. and Wednesday at 10:00 a.m. during the month of October in our Northland Plaza first floor conference room.

Please bring a friend, neighbor, or relative and call us to reserve a spot in one of our upcoming seminars.

## A QUARTER TO FORGET – MARKETS REEL AS ECONOMY HITS A WALL

### MARKET OVERVIEW

What started more than a year ago as a crisis in the subprime mortgage market has spread to the broader domestic economy and is beginning to take a toll globally. An overheated housing boom, driven by low interest rates, an easing of credit standards and the securitization of mortgage instruments, among other factors, has come back to haunt the economy and markets.

The severity of the challenge for the economy today is exemplified by the aggressive efforts of the federal government to try to stem the tide of a steep slide in housing values. Reduced interest rates (by the Federal Reserve) and incentive programs to restructure mortgages have failed to trigger a turnaround. In the meantime, foreclosure rates continue to climb, creating even more pressure on the market.

Mounting losses have forced banks and investment companies to take significant write-offs, or merge to stay afloat. Credit markets froze, banks began to stop making short-term loans to companies, consumers or even each other, drying up a crucial source of cash required for the economy to function. Investors fled to the safe haven of U.S. Treasury bills as confidence waned in even short-term commercial credit.

With the economy appearing to be on the ropes, the federal government had little choice but to pursue unprecedented interventionist measures. In September alone, these included:

- Placing Fannie Mae and Freddie Mac in conservatorship
- Trying (unsuccessfully) to engineer a buyout of Lehman Brothers, leading to the sale of Merrill Lynch to Bank of America
- A loan package worth up to \$85 billion by the Federal Reserve to the world's largest insurer, AIG, so it could avoid bankruptcy
- The proposal by the Bush Administration to inject \$700 billion into a rescue plan, primarily to purchase troubled securities from major financial companies. By the end of the quarter, this measure had cleared only one house of Congress, but was ratified in early October.

While dramatic events overtook market fundamentals in September, the flip side is that good opportunities have been created for long-term investors.

### ECONOMY

#### THE 3RD QUARTER

Although the financial sector was in crises, the U.S. economy actually showed modest growth through the three quarters of 2008. Rising exports, increased worker productivity and profit growth in almost every industry sector (except financials and automotive) helped the nation's Gross Domestic Product rise by 2.8% in the 2<sup>nd</sup> quarter (the last reported quarter). Inflation, driven primarily by oil price hikes earlier in the year, remains high at 5.4%, but core inflation (a measure of living costs outside of the more volatile food and energy sectors) was more modest, just 2.5%.

Industrial production and manufacturing capacity utilization fell 1% in August. The ISM Manufacturing Index declined in September as that critical segment of the economy remained troubled. The service sector has held up better, but that situation could change given continued economic turmoil. Unemployment hit 6.1% in August, the highest level in five years.



All other aspects of the economy currently take a back seat to the housing sector. The Case-Shiller Home Price Index, a prime measure of home values nationwide, is down 15% from a year earlier, and closer to 20% from its peak. The inventory of unsold homes declined slightly but remains high at a 10-month supply. The foreclosure rate is 1.2% and mortgage delinquencies have reached 6.4%. Both are at record levels.

### **LOOKING AHEAD**

The fallout from the housing market's struggles has clearly bled over to the broad economy and more importantly to consumers. Households appear to have scaled back spending and delinquency rates for credit cards, auto, and home loans are rising.

In the near term, the best prospects for the economy probably hinge on the ability of fiscal policymakers to restore order to the credit markets and, ultimately, stability in the US financial system. The Federal Reserve has been aggressive in its efforts to maintain liquidity in the financial markets and is likely to continue to promote ongoing efforts, working with other central banks across the globe. The weakened economy will likely convince the Fed to cut short-term interest rates again soon.

When 3<sup>rd</sup> quarter Gross Domestic Product numbers are reported in October, we anticipate confirmation that a recession is underway (with negative GDP growth). One highly anticipated event will be resolved by early November, when we find out who will be the next President. Markets may or may not appreciate more certainty once the outcome is apparent.

## **BOND MARKET**

### **THE 3RD QUARTER**

Bond markets garnered uncharacteristic headlines during the 3<sup>rd</sup> quarter, as a focus on credit issues dominated the discussion. Corporate bond spreads widened to levels not seen since 2001. Investment grade corporate bonds declined 10.73 in the quarter. Investors flocked to the safety of short-term treasury securities in such numbers that the yield on the 3-month U.S. T-bill briefly dropped to 0.01% in late September.

The flight-to-quality was reflected in 3<sup>rd</sup> quarter results, as U.S. Treasury bonds gained 2.5% for the period. Mortgage bonds responded particularly well (gaining 2.1%) after the government intervened in rescuing Fannie Mae and Freddie Mac. On the downside, Treasury Inflation Protected Securities (TIPS) lost 3.3% as inflation risks appeared to subside, and municipal bonds declined 3.2% as government entities faced funding disruptions due to the credit crunch.

### **LOOKING AHEAD**

It appears implementation of the federal government's rescue plan could be the key to resolving ongoing credit market problems in the short run. It may allow government agency-backed mortgage bonds to generate attractive yields with safety comparable to U.S. Treasury securities to change the landscape in a positive way.

High-quality corporate bonds are generating attractive yields and prices should appreciate once credit markets recover. Also attractive are municipal bonds and select emerging market debt issues. Both may be subject to some volatility, but emerging market bonds offer the additional benefit of diversification away from a potentially weakening dollar.

## **DOMESTIC STOCK MARKET**

### **THE 3RD QUARTER**

Through the end of August the stock market was holding its own. But beginning in September, as the storm hit the financial sector with full force, volatility was dramatic (the Dow Jones Industrial average moved up or down an average of almost 300 points a day for 15 of the 21 trading days). Even federal government officials spoke of fears of a financial meltdown. Stocks declined 8.7% for the quarter as measured by the Russell 3000 Index.

Large cap stocks (Russell 1000) lagged the overall market, losing 9.4%, while small cap stocks (Russell 2000) were down just 1.1%. Growth stocks retreated from their leadership position earlier this year, declining 11.9% for the quarter. Value stocks fared better, but still lost 5.2%.

Surprisingly, given the bankruptcies, bailouts and emergency acquisitions that pervaded the financial sector, financial stocks gained 1.4% in the 3<sup>rd</sup> quarter. Of course, that came after an extended period of retrenchment for financial stocks, so some investors viewed the marketplace as a good value. Consumer staples also performed well, expected for a "defensive" sector in a volatile market.



## Performance Update

### Annualized Returns

Market Index	3rd Qtr	YTD	1 Years	2 Years	3 Years	5 Years
DJ Ind Average	-3.68	-16.46	-19.81	-1.23	3.33	5.65
S&P 500	-8.49	-19.43	-22.14	-4.79	0.14	5.12
Russell 2000	-1.11	-10.38	-14.48	-1.98	1.83	8.15
S&P Mid-Cap 400	-10.87	-14.34	-16.68	-0.53	1.78	8.65
<b>Russell 3000</b>	<b>-8.73</b>	<b>-18.81</b>	<b>-21.52</b>	<b>-4.38</b>	<b>0.26</b>	<b>5.70</b>
MSCI EAFE	-21.05	-31.07	-32.48	-9.23	-1.37	6.97
MSCI Em Mrkt USD	-27.61	--	-34.69	0.56	5.97	--
NASDAQ Comp	-9.19	-21.49	-22.92	-3.98	-1.09	4.38
Lehman High-Yield	-8.89	-10.08	-11.24	-2.30	1.04	3.11
Lehman Agg Bond	-0.49	0.63	3.65	4.39	4.15	3.78
Lehman Credit Index	-6.38	-6.83	-4.79	-0.38	0.86	1.94
Lehman Gov Bond	1.92	4.02	7.90	6.76	5.59	4.34
Lehman Corp	-10.73	-11.64	-9.99	-3.47	-1.25	.58

*The above annualized total returns and betas represent All Star Financial models. Your actual beta may differ depending on your portfolio holdings.*

Two sectors that previously weathered the market's troubles, energy and materials, both lead the decliners in the 3<sup>rd</sup> quarter. Energy dropped 26% as oil prices fell well below the peaks reached earlier in the summer. Materials stocks lost 23%. This setback in stock prices occurred even as most big players in both industries continued to generate strong profit growth. All other sectors declined anywhere from 9% to 16% during the quarter, with markets taking a toll even on industries that continued to generate profit growth.

### LOOKING AHEAD

Fear was clearly the dominant factor driving the markets late in the 3<sup>rd</sup> quarter. So it is not surprising that investors temporarily overlooked the underlying strength of a number of U.S. companies. The pain was so widespread that during the market's worst day in the period, September 29<sup>th</sup> (Dow Jones Industrial Average down a record 777 points), Campbell Soup was the only stock in the S&P 500 to muster a gain. Investors were clearly overlooking that all sectors have positive earnings growth except the financial and consumer discretionary sectors.

We don't anticipate major improvement in the environment for financial or consumer discretionary issues for the rest of 2008. Slower growth is also likely for more resilient sectors such as energy, materials, industrials, and technology. But eventually, investors are likely to recognize attractive stock valuations and a rebound should ensue. We anticipate that the combination of lower interest rates and more modest inflation (thanks to declining oil prices in the short term) will be a positive catalyst for stocks in early 2009.

## INTERNATIONAL MARKETS

### THE 3RD QUARTER

As has been the case much of the year, global markets offered little respite from the problems plaguing U.S. markets. It is clear the effects of the subprime mortgage mess and subsequent financial crises are being felt overseas as well, with a number of economies at risk of a recession. As a result, the MSCI EAFE Index declined a whopping 20.6% in the quarter, with every region and country losing ground. European stocks fell 21% while Japan's market lost 17.5%. The downturn was even more dramatic among emerging markets, off 27.1%. Worst hit were export-driven Asia Pacific markets, down 25.5% and the commodity-based Latin American markets off 31.5%.

### LOOKING AHEAD

Central bankers abroad appear to have little choice but to join the Fed in lowering interest rates in an effort to stave off a deep recession. The European Central Bank has been aggressive in providing liquidity to banks and Europe has promptly addressed issues related to troubled financial institutions.

Japan and developed markets in Europe are likely to be forced to deal with the global economic slowdown for several quarters. Growth is slowing in other regions as well, but we remain optimistic that emerging markets will fare better. In particular, China and India, while growing at a more modest pace than previously, still are supported by factors such as a growing middle class and rapid advancements in many industries. That should help contribute to a more favorable environment for emerging market stocks.

## SUMMARY

We can only hope that we never have to live through another quarter like the 3<sup>rd</sup> quarter of 2008 any time soon, particularly the jarring developments of September. Government intervention appears to be critical to stave off further economic deterioration, and hopefully will play a role in getting the economy back on a positive track. Barring any dramatic developments, we anticipate the consumers will moderate spending in the 4<sup>th</sup> quarter, which will make the environment more challenging. Ongoing job losses in the economy are contributing to a cautious sentiment when it comes to household spending. Businesses also may be forced to maintain a conservative stance, at least until the credit markets free up more capital.

Given these headwinds, the environment is likely to remain somewhat volatile for the rest of 2008. Our emphasis now is on positioning our portfolios to benefit from a recovery that is anticipated in 2009 and beyond.



# What is Happening?

*Nothing that has not happened before!*

Looking back at history, we can actually see that the time period we are going through, although fairly extreme, is not unusual and certainly not the first time. As you can see below we can go all the way back to 1857 and show how **GREED** in the insurance industry created a panic, or just look back as recently as the Dot.com bubble of 2000 when the market dropped an amazing 49%.

## Panics of the Past

- 1857 – Ohio Life & Trust Company fails
- 1875 – Largest bank in the United States closes its doors
- 1893 – Reading Railroad went bankrupt
- 1907 – J. Pierpont Morgan intervened and ended the “Banker’s Panic”
- 1918 – Post World War I recession
- 1929 – Black Thursday and the Great Depression
- 1953 – Post Korean War recession
- 1957 – Auto industry plummets
- 1973 – Oil Embargo recession
- 1980 – Inflation hit record highs – 21.5%!
- 1987 – Savings & Loan Crisis – Government bailout
- 1990 – Japanese Real Estate Bubble
- 2000 – Dot.com Meltdown
- 2008 – Housing/Credit Crisis

\*Many of these events have a lot in common and **GREED** can be pointed to as the root of most of these situations.

## How Long Will This Last?

*The last 10 recessions – Starting in June 1946*

- \*Average length = **11 months**
- \*Total time from Top to Bottom = **15 months**
- \*Total decline in S&P 500 = **-32.6%**
- \*Next 12 months average rebound = **+30.8%**
- \*Average number of months during expansion = **68 months**
- \*Average bull market return = **+176%**

## What Do I Do Now?

1. Reassess your risk tolerance – if need be...Rebalance
2. Take advantage by putting more money into the market – Dollar Cost Average!
3. If you have 3-5 years before the goals for your specific bucket of money changes, Stay the Course

**This has happened before, and it will happen again!**

### ALL STAR FINANCIAL

3800 American Blvd. W.  
Suite 750  
Minneapolis, MN 55431

Phone: 952-896-3820  
Fax: 952-896-3819  
Toll Free: 888-809-7901  
E-mail: [asf@allstarfinancial.com](mailto:asf@allstarfinancial.com)  
Website: [www.allstarfinancial.com](http://www.allstarfinancial.com)

### ASF CONTACT INFO:

<b>Bob Klefsaas, CFP, AIF</b>		<b>Jeff Elavsky</b>	
President:	952-896-3816	Account Executive:	952-896-3828
<b>Maren Aipperspach, CFP</b>		<b>Kris Collins</b>	
Vice President:	952-896-3817	CPA	952-896-3829
<b>Bruce Bonner, CFA</b>		<b>Evan Klefsaas</b>	
Research Analyst:	952-896-3818	Paraplanner:	952-896-3815
<b>Nick Hohn</b>		<b>Valerie Moorehead</b>	
Account Executive:	952-896-3823	Executive Assistant:	952-896-3826
<b>Paul Sommerstad</b>		<b>Teri Neff</b>	
Account Executive:	952-896-3835	Office Manager	952-896-3820