

ECONOMIC RESCUE PLAN CONFERENCE CALL TRANSCRIPT
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KR: Thank you for joining us for our teleconference interview on the current economic situation, the Congressional Emergency legislation and what you should be doing now.

I'm Ken Robinson, senior planner at The Monitor Group. Joining me are Glenn Kautt, president, and Cal Brown, vice president of The Monitor Group.

During the next 45 minutes or so, they'll be discussing and analyzing what's going on with the current economic and investment situation, and talking about things you should be considering.

Because of the time limitation, we can't take your questions during this teleconference. However, many of our clients have asked questions about these topics, so I'm going to be asking Glenn and Cal the questions you've asked us. We are making a recording of this session, and it will be available on our website next week.

If you have questions as a result of this discussion, please give us a call to set up a time we can talk with you one-on-one.

Now, let's get started.

Glenn, can you give us your insights on the economic situation?

GK: Ken, I don't think anyone can give a perfect description of everything that's happened, as the situation has not resolved itself completely. This is my best analysis to this point, and I'm sorry to say its quite complex. I'll summarize key points as I go along.

Let me start by saying there is much to be angry about:

- home-buyers who bought homes they couldn't afford
- banks who took on too much risk
- brokers who sold too much junk
- CEO's who failed to manage, but got big paychecks, and
- politicians who failed to lead

However, just being angry won't get us very far. Let's consider what happened and what we might do about it. This credit crisis started long ago. 30 years ago, residential loans were made by local banks. They would carefully analyze the risk factors by doing something called underwriting. They'd offer loans at an appropriate interest rate based on risk. If the rate was too high, the loan wouldn't happen. The bank's capital was at risk and underwriters were careful to evaluate every loan.

In the late '70s, investors were demanding more yield. Higher yield mortgages, know as "sub-prime", became the investment opportunity, but institutional investors couldn't lend money individually. To do this, packages of residential-mortgage-backed-securities (RMBS) were developed.

I personally invested in them briefly in the 1980s. In the early 1990s something else developed. Investment banks created a tiered (that's "t-i-e-r-e-d") structure, and divided the pool by risk. The lowest risk went into the top 80% of loans, the next tier 10%, Then 5%, 3% and the riskiest bottom tier 2%. Suddenly, a large portion of the MBS portfolio was: quote/unquote "SAFE."

So, in summary, the ground was plowed up and made fertile by the packaging of billions of dollars of these mortgage-backed loans.

The seeds of destruction were sown as mortgage brokers didn't have to do the tough underwriting. This decoupling of lenders from underwriters meant underwriting standards were dramatically relaxed. Appraisals were sloppy or sometimes fraudulent. Less scrupulous brokers were attracted to the industry.

In summary, what we're seeing today is the result of the decoupling of risk analysis and lending.

In the 90's, the idea of tiering the pool became even more sophisticated. In particular, the third tier representing 5% of the total pool was itself tiered into five segments. This new security was called a collateralized debt obligation or CDO. The word mortgage was not

used in this investment. This was more Wall Street baloney, where 70% of formerly BBB rated investments were turned into AAA!

Some inventive investment banks created CDOs being paid by other CDOs. This craziness was supposed to diversify, when in fact it was just one house of cards being built on another risky house of cards.

Portfolios became more and more opaque. When you look into a muddy river, you rarely wonder what's at the bottom. By the end of the 1990's, people stopped looking into these murky portfolios as they became more risky.

As the hunger for more lending and more investing increased, regulators, Freddie Mac, Fannie Mae and the investment banks pressed hard for relaxed lending standards starting in the early 1990s. The White House agreed, so other asset based securities, backed by student loans, credit card debt and repackaged forms of other loans surged.

By this time, the regular banking system had morphed into something inherently more risky, the so-called shadow banking system. With no oversight, no audits and no controls, massive cash flows fueled growth, but no one can really see through the opaque pyramiding of debt. How about Reserve requirements? There are none!

Other issues were developing. Hedge funds, in particular, borrow money to invest using leverage of 10:1, 15:1 or even 30:1 ratios. They'd borrow short-term money at lower rates, and invest in various securitized pools with a higher return, earning the spread. This was all viewed as very safe, since the underlying investments were AAA rated, weren't they? Wink-wink!

Well, a \$100 billion hedge fund called "Long-Term Capital Management" vaporized in the mid-1990s, because they didn't understand the underlying risk, even though they weren't using mortgage backed securities for all their investing. It nearly caused a meltdown of the financial system. Fed chairman Alan Greenspan intervened, and solved the problem with private capital. That should have been a warning, but nothing much happened in the regulatory arena. What's happened since then? Tiger Funds, Marin Capital, Aman Capital. Billions of dollars gone.

Another result of all this creative packaging was the structured investment vehicle, or SIV. It's an investment that borrows money and uses it to invest in generally AAA rated asset-backed securities. Because SIVs used leverage, SIVs earned good returns.

However, something important was happening. During the 1990s and early 2000s the rating agencies, investment banks, insurance companies and investors themselves assumed a slow increase in property values, and only a modest default rate. In other words, the possibility of a nationwide real estate recession wasn't even in the equation the rating agencies used to assess risk, as the U.S. had not experienced a nationwide decline in home prices for over seven decades.

So, by the late 90's the house of cards had already been built, aided and abetted by the administration, Congress, regulators, Wall Street and a global group of investors.

But when a substantial number of adjustable rate mortgages started to reset in the 2003-2004 timeframe, the system started to break down. All the poor underwriting, predatory lending, use of highly-leveraged investments and complete misunderstanding of how to calculate risk in this arena had created a time bomb. When the real estate market peaked in 2006, declines in property values and increasing default rates were already happening.

The losses were magnified because of the tiered structure of the CDOs and other asset backed securities. All the "creative" packaging had done nothing to properly diversify risks, which were nearly impossible to calculate.

By 2007, as losses began to mount, lenders began to call their loans in or refuse to renew credit lines, so hedge funds were forced to sell the liquid part of their holdings, leaving them stuck with essentially illiquid assets. The same thing happened with SIVs, but since they borrowed short term, they found was the money market funds that loaned them money, lost interest. To the funds, SIV returns just weren't worth the risk.

Now, there were very few losses in 2007 from SIVs, but MM funds' concern of material losses were real. The result was a self-fulfilling prophecy: every few weeks SIVs need to refinance, but very few funds were interested in issuing loans to them. So, SIVs were forced into partial liquidation and loan renewals to SIVs dried up. No buying, no renewing of loans, nothing, which resulted in the fire-sale of assets.

Well, this rapid unwinding caused other investors in the asset-backed lending universe to take notice. Hey, what's going on in this normally dull SIV market? When they started to look deeper in the pools they were invested in, they *could not* I repeat, could not calculate the underlying risk. Many became wary of every asset-based security. What was safe, and what wasn't, couldn't be easily understood, because of the complicated tranching and multiple sourcing, so liquidity started to dry up. The entire universe of CDOs and asset-based securities – safe or not- had become tainted by association.

This is an example of reflexivity, where the biases of individuals enter into market transactions, changing the fundamentals of the market equilibrium. More on that later.

Because no one could quickly figure out the underlying risk and value of much of the asset-backed securities, this forced more liquidations, which led to the sell off in the broad equity markets in the fall of 2007. Hedge funds could no longer borrow cheaply, were losing money, and were forced to sell liquid securities. That's still happening right now. This unwinding or "de-leveraging" is one cause of the tremendous downward pressure in the markets now.

As a result, many of the investment banks saw the only way out was to raise equity capital, but as the equity markets continued to decline, investors stopped investing in them too.

Without outside capital, investment banks were driven to their knees, and this is what happened to Bear Stearns. Many have asked, why not let firms like Bear Stearns fail and be bought for pennies on the dollar by someone else?

Well, it ties back to their balance sheet and one other big thing—I'll get to that in a minute. Although the equity value of their loan package might be worth, say, \$30 billion, it could go to zero. So, the whole deal is worthless, right? No, because there are liabilities offsetting these assets. If all the assets fall to zero, it doesn't mean the liabilities go away. This means net equity could go negative. And who wants to buy something with a possible negative net worth? The answer is: nobody.

Here's the other big thing.

The Fed might not have intervened in Bear Stearns if it wasn't for the derivative situation, and that's where we are today. These derivatives are private contracts negotiated between parties. This is not a derivative such as a futures contract traded in a regulated commodities exchange. The fear of the feds is over a contract called a credit default swap (CDS or SWAP). The CDS is an insurance policy against the risk that a particular company's bond or other financial instrument defaults.

SWAPs took off because investment banks and hedge funds could strike a private deal in a minute, with little or no cash up-front, and they didn't have to own the underlying security or bond. In simple terms, anyone could place an insurance bet on anything, and didn't have to own it. What started out as a hedging vehicle ended up giving investors a cheap, easy way to wager on almost any event in the credit markets. One hedge fund,

Paulson & Co. (not related to Sect of Treasury Paulson) made \$15 billion in 2007 betting against sub prime mortgages. Crazy!

In one sense, it's a large unregulated insurance market, but actually, it's the world's largest unregulated casino!

Now, here's the issue the feds face today: SWAPs, developed in the 1980s, were just under \$1 trillion in 1999. Unfortunately, they've grown exponentially to about \$54.6 trillion today.

Bear Stearns was the counterparty-issuer to a lot of SWAP, possibly as much as \$3 trillion. If Bear defaulted, financial institutions which had no direct relationship with Bear other than being insured by a Bear swap would find themselves with losses as their insurance coverage was written down to zero, and their asset-based securities were instantly devalued.

In summary, the fed's bailout wasn't to save Bear employees or fat cats but to facilitate the buyout by JP Morgan to avoid a potentially catastrophic counterparty default, and give enough time to liquidate Bear's assets to close out some of their derivative contracts to reduce the potential losses.

I'm going to turn the commentary over to Cal to talk about what's happening now.

CB: As Glenn just mentioned, large capital infusions weren't forthcoming towards the end of 2007 and during 2008 prior to federal intervention, so the only answer in the past year was to sell assets and reduce leverage. Glenn mentioned Bear Stearns. Well, many people hoped that closing Bear Stearns would help to finally fix the problem. Unfortunately, because of underlying problems including declining real estate values and more severe losses on asset-based securities, the investment situation has continued to deteriorate.

The problem, selling at a reasonable price takes a willing buyer. With confidence in the real estate markets declining, the only assets that got sold were at fire-sale prices. This brought Financial Accounting Standards Board Rule 157 into play. Basically, Rule 157 states financial institutions that carry investments must generally mark, or value, them to the latest market price called "Mark-to-Market." However, the problem comes when numerous financial institutions and large scale investors are trying to sell the same assets at the same time. When one bank sells at a depressed price, it causes the mark-to-market value of RMBs for all the other banks to decline, meaning they also have to sell to meet

their financial obligations, but they have to sell a larger portion. This depresses the price even further. Soon, you have a descending spiral no bank can avoid. Mark-to-market rules have been suspended in the new legislation, as I'll discuss in a minute, but much damage has already been done.

As you may know, Fannie Mae and Freddie Mac provide funding for a substantial amount of domestic mortgages. For Fannie and Freddie, their balance sheets were leveraged almost 50:1 thanks to Congress' explicit approval, so they couldn't afford any losses at all! The loss of these institutions would have caused a severe decline in the availability of mortgages to a broad segment of America.

To make matters worse, there is a huge amount of swaps written on their debt, possibly as much as \$30 to \$50 trillion of the total of \$54 trillion Glenn mentioned a few minutes ago.

Thus, government intervention wasn't just to help a few homeowners, or bail out some executives. It was to prevent the risk of almost immediate default and potential settlement on trillions of dollars of guarantees. The injection of capital allows the feds to buy the bad debt at a price which will probably eventually net the government and taxpayers a small profit, or possibly a small loss. The alternative is huge global financial market instability and a lock up of regular credit.

Here's why. The rapid pace of institutions' failures means the problems is not *just* declining real estate prices or the rapid sell-off of asset-based securities. It's that the financial institutions don't trust each other to stay in business, and consequently won't let any cash out their doors. That's a very serious problem.

The problem of distrust could lead to dramatic results in the credit markets. Imagine you go to the store and use your credit card, which is refused. You call the card company, knowing you've paid your bill, and someone tells you they just aren't issuing credit today. It doesn't matter what you say or do, or how much money you have in a bank.

Now, imagine you are a small or large business, and you go to use an existing line of credit to finance inventory. The same thing happens. NO credit today! You can't get inventory, and the factory has to shut down until cash can trade hands and inventory is shipped. Workers are idled, wages decline, you get the picture.

Regardless of the financial damage, many banks feel they have no choice. Even an overnight loan to another credible major bank might be met with news in the morning of

a failure, a loss of the assets, and a capital call. *That's* why the Fed stepped in, to provide guaranteed credit.

Let's talk about the rescue bill, officially called the **Emergency Economic Stabilization Act**, passed just last week:

Here are the major provisions of the **Act**:

TARP – Troubled Asset Relief Program

\$250 Billion is available immediately to purchase mortgages and other assets. The President can authorize another \$100 Billion. Also, another \$350 Billion may be available if the President certifies it is necessary and Congress does not disapprove.

Oversight of TARP

There are several Oversight Boards, a new Inspector General and others who will be reporting frequently to Congress. In addition, there will be Judicial Review – courts have authority to review actions of Treasury & TARP.

Insurance Program for Troubled Assets

Also, the Treasury Dept. will establish an insurance program for troubled assets, charging a risk-based premium.

Taxpayer Protections, including stipulations that:

Revenues from the sale of troubled assets will pay down the national debt.

And, FDIC insurance is temporarily raised from \$100K to \$250K per acct until 12/31/09.

Regarding Executive Compensation

Treasury will establish compensation standards for the Top 5 (“senior”) executives of institutions whose assets are directly purchased under TARP. Also, there are prohibitions on golden parachutes.

Mark-To-Market

SEC has authority to suspend mark-to-market accounting requirements for any issuer or for any class or category of transaction

There are also three Unrelated Tax Provisions which may apply to you:

AMT Patch

The AMT exemption is increased with the intent that if you were not subject to AMT in 2007, all other things being equal, this should protect you from AMT in 2008.

Disaster Relief

There are tax benefits for taxpayers in disaster areas, similar to the Katrina Emergency Tax Relief Act of 2005.

Sales Tax Deduction

Extends the deduction for state and local sales taxes.

KR: *Cal, isn't it true when various pieces of legislation have been enacted in the past, it resulted in unintended consequences?*

CB: Yes. Actually, a perfect example was the tax reform act of 1986. It removed so-called tax breaks or loopholes for real estate investors which were enacted during the late 1970's and early 1980's.

What resulted was the collapse of the commercial real estate market. That led to a rash of savings & loans failures (remember the Keating Five scandal?), the collapse of a number of insurance companies with large investments in commercial real estate, the meltdown of the junk bond market and failure of Drexel Burnham Lambert.

That caused the federal government to form the Resolution Trust Corporation, which oversaw the liquidation of billions of dollars of properties and the failure of over 800 banks nationwide. All in all, it took about three years to drive back out of the downturn created by all the legislation and regulatory "see-sawing" during the 1976-'86 timeframe.

KR: *Glenn, could that happen this time?*

GK: As Cal mentioned, the legislation does not contain any major change in the tax code. However, new tax legislation might happen during the next administration, which could cause an unintended economic impact. We'll have to wait and see on that one.

Having said that, the amount of liquidity being injected into the domestic economy by this bill, plus similar government actions by other major countries such as England, Japan

and Germany, will undoubtedly have some kind of impact. I suspect it will be more positive than negative in both the short and long term.

KR: Some of our clients have asked questions about Schwab. From everything we read and hear Schwab appears to be sound. Here are some Schwab resources if you're are interested in details. You can visit WWW.ABOUTSCHWAB.COM. You can also visit our website where we have posted copies of the following documents from Schwab: "Asset Protection with Schwab" and "Q&A Regarding Schwab's Money Market Fund Holdings."

Ok, let's get to the questions. Cal, here's the first one.

KR: *You have told us repeatedly The Monitor Group is a "pre-eminent risk manager", but my portfolio value has gone down. What does that mean?*

Managing risk does not mean eliminating all risk. In fact, there is absolutely no risk-free investment.

What we do well is reduce risk by reducing volatility. For example, as of Sept 30 our typical 60/40 portfolio has retreated 12% before subtracting fees. During the same period, other indexes were much more volatile, retreating between 20-30%. The market continues to be extraordinarily volatile, with many major indexes down 40% or more as of Friday. Our 60/40 portfolio is down 23.8% as of Friday. In one sense, that's not good news, but your substantial diversification across all of the asset categories has you poised for a remarkable comeback when the credit situation is stabilized.

KR: *Cal, how long before the economy bounces back? How long for the markets to recover?*

Wow, if we knew the answer to that, we could all place one bet and go to the Caribbean! Seriously, no person on the face of the planet can forecast or predict that. However, history tells us after every recession growth accelerates. Please refer to my August memo "Back to the future—2008 markets" for those statistics, which you can find on our website.

In the realm of active investment management and stock pickers there is a discipline known as technical analysis. A money manager engaged in technical analysis recently explained to me that last week, only 14% of NYSE stocks were above their 200 day moving average. This low level has only been reached 3 other times in the last 15 years,

and in each case was followed quickly by a dramatic increase. So, although no one knows, the markets could recover sooner than later.

KR: *Glenn, how long will the current economic crisis last?*

Again, Ken, we don't know. However, for anyone who's listening. If you are concerned whether your assets will be depleted or substantially affected, talk to us during your next review meeting, or call the office to set up a phone call or meeting right now.

KR: *Cal, which banks and institutions are safe? What about Schwab?*

For banks, there are a host of regulators and the FDIC. Your FDIC accounts are now insured to \$250K. FDIC does not apply to your investment accounts. Your investment accounts are not insured against investment loss. A custodian has no claim or ownership on the assets in your account. Your investment accounts are insured against fraud to \$500K, and Schwab maintains additional insurance for fraudulent actions of their employees, such as embezzlement. Even so, some banks are going to fail because of their exposure to subprime mortgages or other risky investments. So, do not maintain more than \$250K in any one account.

KR: *Glenn, how much AIG, Fannie Mae, Freddie Mac, and Wachovia are/were in the portfolio?*

For the TMG 60/40 portfolio, 11.1% is in Large Cap Growth which included all of those particular stocks. Based on Vanguard 500 Index Fund holdings as of June 30, a \$1 million 60/40 portfolio had the following dollar amounts:

FANNIE MAE	\$ 206
FREDDIE MAC	\$ 105
AIG	\$ 707
WACHOVIA	\$ 330
LEHMAN	\$ 138

For a total of \$1,487 or .149% of your million dollar portfolio.

CB: Glenn, let me add something else. Recently, I heard the author of the NY Times best-seller, The Black Swan: The Impact of the Highly Improbable. He spoke at a financial planning conference and he agreed with us at The Monitor Group that stock market returns are not “normally distributed”; rather, they are “leptokurtic.” That means

they don't have a smooth bell curve. Rather, the distribution of events has "fat tails." Fat tails are Black Swans, but they happen more frequently than one would predict using the normal or bell curve distribution. The current bear market, just 5-6 years after the 2000-2002 bear market, is a "Black Swan." Positive Black Swans are also out there in the future. The two main take-aways from his talk were:

- 1) Don't over-leverage yourself
- 2) Avoid the BIG Mistakes

We have done both for many of you. We have advised many of you to pay off your mortgages, although in some other cases we have advised prudent levels of debt are OK, because you can always pay them off.

Second avoid the big mistakes. One of the biggest mistakes any investor can make is having a concentrated position in one, or just a few, individual stocks. This has had devastating consequences for employees of Enron, and more recently Lehman Bros., Washington Mutual, and Wachovia. Some of you experienced this or knew friends who were badly damaged during the high tech bubble burst. We don't take on clients who refuse to sell their big positions in single stocks. It's a big mistake! Diversification and scientific asset allocation will avoid that BIG mistake.

KR: *Glenn, where is the portfolio most exposed? Is there a specific bank or company the portfolio is invested in heavily?*

Ken, there is no company in which the portfolio is heavily invested. Actually, that's one of the best things about being properly diversified. Using the one million dollar 60/40 portfolio, your largest position is about \$430 of Exxon Mobil, the biggest company in the world.

KR: *Glenn, speaking of ExxonMobil will oil go to \$300/barrel?*

Yes. But probably not in my lifetime, or yours either. Right now the price is below \$90 bucks a barrel. Gas prices have come down rapidly, almost instantaneously! It's important to reflect on this. Just a few weeks ago, so-called "experts" were worried oil might go to \$200 a barrel. Of course it didn't and here's why: shifts in demand.

As a former energy consultant I know a bit about energy economics. Here is something else *very* positive to think about:

Within twenty years we'll see a massive shift in energy sourcing. Low head and regular hydropower, coal gasification, nuclear power, solar, geothermal, and wind will be leaders in electric generation. Electric and hydrogen fuels cells will be used for the vast majority for light transportation. Natural gas, gasoline and diesel will be used by the heavy movers, such as trucks, aircraft and ships. Either the markets will force alternatives by pricing oil upwards, or the government will mandate alternatives by penalizing petro-burning vehicles and power plants. More than likely, some of both will occur, which will keep oil prices down. More importantly, the US won't be using much foreign oil, if any.

KR: *Cal, what portion of the portfolio is insured by FDIC? What is SIPC?*

FDIC is for bank deposits. It does not apply to your investment account. SIPC insures up to \$500,000 per account against fraud.

KR: *Glenn, what opportunities are out there now?*

Well, we're not sure about individual investment opportunities, but we do have some thoughts about our diversified portfolios coming up at the end of our Q&A period.

KR: *Cal, should I get out of equities now?*

No. Selling at the bottom or near bottom is never a good investment strategy. I mentioned technical analysis earlier; there is another discipline known as "fundamental analysis"—this is a bottom-up, company by company analysis of their fundamental value. I'd like to talk briefly about "fundamental analysis." Some of America's largest and most stable companies are outstanding values now. For example, you may have heard that Warren Buffett recently purchased a large block of General Electric stock. GE is paying a dividend yield of 6% and has P/E ratio of under 10—normally it is 15-20. Its stock price has been punished recently, and is now around \$20/share. If it gets back to the \$30 range where it was in June, an investor could make a 50% profit, and is being paid 6% while they're waiting! There are many other companies just like that.

There is now so much cash sitting on the sidelines that eventually institutional investors and individuals too will recognize these values are too good to pass up, especially with interest rates as low as they are on money markets or other cash equivalents.

You might remember the Chinese symbol for the word "Crisis" is the combination of two symbols: one meaning "Danger" and the other "Opportunity." That is exactly where we are today—it is dangerous in the markets, but there is tremendous opportunity as well.

KR: *Glenn, what should I do about my 401(k) or Thrift Savings Plan at work?*

Speaking of opportunity, if your current retirement plan has equities in it, continue to invest as much as possible. I'm doing just that because I want to buy equities that are really underpriced now and will appreciate substantially. Just make sure you don't have a concentrated position in your own company stock. The prudent investor rule suggests no more than 5% of your portfolio in any one investment such as company stock.

KR: *Glenn, now that the bailout bill has gone through, what will be the result? Will the bailout work?*

Absolutely. The bailout will work, because the current administration, both contenders for the White House and the entire Congress all understand the gravity of the situation. While there will be politicking, they are working for a positive outcome.

KR: *Cal, my portfolio went down 20% recently. Is it possible to earn it back in the short term?*

Yes, it is possible for the equity portfolio to earn it all back in one year. That happened in 2002 and 2003. In 2002 it returned -19%, and in 2003 it returned +42%. A recent analysis of the 9 Bear Markets since 1957 revealed the recovery in the first year after the market bottom was quite robust.

Now, a bear market is a prolonged period in which investment prices fall, usually by 20% or more, accompanied by widespread pessimism (sound familiar?). Bear markets usually occur when the economy is in a recession and unemployment is high, or when inflation is rising quickly. Fears of further declines and market volatility make investors skittish, with many pulling money out of the stock market after absorbing much of the decline.

But then they risk missing the subsequent rebound after a bear market, which historically has been very impressive. In fact, in every case except one for these 9 Bear Markets, the first year after the market bottom had the highest return, but the second and third years were not very impressive. The average of the 9 Bear Markets was 1st year up 36%, 2nd year up 12% and third year up 1%.

So if you miss the rebound, you missed most of the opportunity to earn it back.

KR: *Cal, if I have come into some cash recently, what should I do with it?*

That depends on your needs and personal situation. Please call us to discuss this in detail.

KR: Well, Glenn what should our listeners do now?

Cal just mentioned Warren Buffet. We were asked “what would Warren do?” We answered Warren Buffet, perhaps the most successful individual investor of all time, is buying stocks again, just as he has done in many past down markets. About three weeks ago, Buffet invested \$5 billion in Goldman Sachs, an investment banking firm which has now converted to a commercial bank. Buffet is confident we’ll get through this market turmoil and you should be too.

We are not suggesting you should invest like Warren Buffet. He made his billions by taking *huge* risks in concentrated investments. He is not diversified and is playing a very different game.

It’s more appropriate for most of us to stay committed to our long-term investment strategy. You may be thinking, is Glenn saying it is more appropriate for us than for Buffet to take stock market risk? No, no, no. Mr. Buffett requires only a small fraction of his wealth to preserve his financial security.

Warren Buffet and his heirs can live very comfortably if he invested all his wealth just in fixed income. On the other hand, those of you who are listening may have several million in assets and are thinking all fixed income sounds good right now.

Well, that might or might not work. Here’s why: most of us need the returns equity investments provide to achieve all our financial objectives. To do so, we have to invest in the most sensible, disciplined manner possible.

Unfortunately that doesn’t happen for most investors. Cal was just talking about that.

Most investors fail to capture a significant portion of the equity returns for the simple reason they are not in the market when they go up. Markets go up because people are buying, driving prices up. The uninformed and undisciplined investors are most aggressively investing at the top of the market when the reverse would be most appropriate.

Markets go down because people sell and prices go down. This means the majority of the investing population - the uninformed and undisciplined - are conservatively investing at the very bottom of the market when they should be most aggressively invested, like Mr. Buffet.

Something else to consider. You may have heard some media sources call the 2000’s the “lost decade.” From July 1998 through June 2008 the total return on the S&P 500 Index was a paltry 2.9%, not even keeping pace with inflation. The annualized S&P 500 return

from January 1, 2000 through September 30, 2008 was an even more disappointing 0.13%.

On the other hand, a diversified portfolio fared much better in the same period than the S&P 500. From January 2000 through September 30, 2008, it returned 4.4%. That says something about diversification.

These past results aren't a guarantee of any future performance or market volatility. There have always been ups and downs in equity investing and that will continue. Quite frankly, with more de-leveraging occurring even as we speak, the markets will remain volatile, and may be driven further south for a while.

However, we know this for sure. A globally diversified portfolio of stocks represents ownership of the means of production and distribution of the goods and services we buy every day around the world. This production and distribution isn't going away, ever.

On the other hand, making selective bets like Mr. Buffet, or betting on some opaque investment you can't understand almost always guarantees a bad surprise in your future.

KR: *Cal, what do you recommend our listeners do?*

CB: Before we can advise what to do, we must consider what the possible alternatives are. We have identified essentially four alternatives:

1. Go to cash
2. Sell stocks short.
3. Invest in something "different."
4. Maintain the discipline of asset allocation, re-balancing, tax loss harvesting and all the other evidence-based tenets of our successful philosophy

Let's look at each one, briefly:

1. Go to cash – this is really not investing; it is sitting on the sidelines. There are several serious problems with getting out of equities and going to cash you may not have thought of; first, the low interest rates on money markets and CD's means there is no way cash equivalents will outperform inflation and taxes, plus provide you the lifestyle you want in the future. The second problem is: when do you get back in? And, do you get back in all at once? Or, gradually over time? Third, if you miss the eventual turnaround I talked about, by waiting until it "feels good" to get back in, but you miss the first big

year, you will have missed the best performance -- and you can never make that back. We have some clients who experienced this back in 2002-2003.

At the risk of sounding over simplistic, remember, if you are riding on a roller coaster, the only way to get hurt is if you jump off!

2. Shorting stocks is a legitimate investment strategy. But, it is betting stocks will continue to go down. There are several hedge funds, ETF's and mutual funds which do this. If we actually believed the markets would go down significantly from here—if we knew for sure that was going to happen—this is what we would do.

As of last Monday, the top performing funds for both the year and the third quarter were funds that shorted various benchmarks. The best performing fund for the year is an ultra-short fund that bet against an international index.

Frankly, this is too speculative for us or our clients, because we have to have some sense of when to get in and out. That would mean we'd have to become market timers, and we don't know how to do that.

3. Investing in something “different.” We have recently added emerging markets and U.S. Treasury TIPS to your portfolios. A speaker at the recent investment conference said TIPS are the absolute best thing and went so far as to recommend 50% of clients' portfolios be devoted to this investment.

While we agree TIPS are good, we're not going that far because that's too much concentration in one asset category. While Emerging Markets and TIPS are excellent non-correlated asset classes, they are still in the category of stocks and bonds, that is, financial assets.

We are considering something quite different, and that is REIT's – Real Estate Investment Trusts. It is something we have analyzed before and have not implemented because so many of our clients own so much real estate already. However, we may reconsider, as real estate may be a very good buy at these low levels.

We are also considering commodities. Commodities performed very well when the dollar was dropping and oil was rising, but now that has reversed. That is some very good news, as oil and gas prices have retreated. Historically, commodities have been a good diversification story, but we are still debating the timing and amount to invest, if at all.

Another perspective on something “different.” You may have heard of the excellent returns reported by the Yale and Harvard endowments. I’ve read and heard and studied quite a bit about these endowment investments, and a large percentage of their allocation is to illiquid investments such as timber land and energy drilling programs.

At that investment conference I had long conversations with two separate energy drilling programs. They each have interesting distribution schemes, along with some tax benefits. But they are illiquid. That means if something starts going wrong, you cannot get out!

For any of you who have ever invested in limited partnerships, you know how painful that can be. This type of alternative hasn’t been considered by our Investment Committee; I’m only mentioning it to tell you there are a whole host of different and interesting investments out there, but that doesn’t necessarily mean they are good for you, even though they might be appropriate for a very large endowment with a different time horizon and objective than you have.

4. The fourth alternative: maintain the discipline of asset allocation, re-balancing, tax loss harvesting and all the other evidence-based tenets of our successful philosophy. One of our clients continually reminds me why they are Monitor Group clients; in their words, “Your interests are aligned with ours.”

If we were compensated on transactions, like many brokers are, we could make a lot of money moving your funds around to different investments. Since we are compensated based on the assets we manage, our firm revenues are being affected the same way your portfolio values are being affected, and we don’t like it!

In addition, we have our personal life savings invested the same way you do, in the exact same investments. I am 100% in equities, so I am definitely feeling your pain.

So, we are making the decision to do what is best for you, and it is also best for us. If we truly believed some other approach was better for both of us, we would do it. We firmly believe this crisis will end, and the subsequent rebound will be significant. If we didn’t believe it, we would short stocks, or buy illiquid investments, or do something different.

Remember, the most important consideration is time horizon. For upcoming withdrawals or cash needs, most of you have significant allocations to short- and intermediate-term bonds and now U.S. Treasury TIPS.

But, for the rest of your life, 10-20-30 years or more, equities will provide the future lifestyle and financial security you need and desire. Many of you want to leave a legacy

beyond your lifetime. The prudent allocation between fixed income and equities over a long period of time will give you the lifestyle you want and provide a legacy for your kids, grandchildren and other objectives.

Now, there are other strategies to implement on a case-by-case basis, with our counsel:

- Convert an IRA to a Roth IRA at these low values; the tax on the conversion will be less, and all the future growth and withdrawals will be tax-free.
- Exercise stock options if “in the money”; don’t flip them. Your tax on the exercise will be less. Hold the shares for a year and then sell at lower capital gains tax rates.
- Run or re-run a Financial Independence Analysis, especially if you are withdrawing from your portfolio. This is critically important. We can analyze and determine if any adjustments need to be made; remember, our Monte Carlo/stochastic modeling which is part of this analysis takes into account bear markets like this one.

GK: To wrap up, earlier I mentioned reflexivity and Cal mentioned leptokurtic, a couple of big words. They are both describing the Black Swan phenomenon we’ve seen in the past few weeks, namely, a loss of confidence in the financial system globally, and a reflexive, almost knee-jerk reaction by investors. Currently, the market is not reacting efficiently. It is gyrating by overshooting in a negative direction. The fundamental values of the underlying investments are much greater than today’s market prices.

Because we are not market timers, we can’t get in and out of the markets. No individual or computer program can competently or safely do this on a repeated basis with large amounts of money. Nobody can do it, period. So, we will avoid that big mistake.

Here’s one more thing we can and are doing for you. We are examining each portfolio in detail where there is a combination of equity and fixed income, and determining if rebalancing, that is, buying incredibly underpriced equities, is a good move at this time. For others, we may be able to generate additional tax-loss trades. We are doing all of this on a case by case basis.

Having said that, some of you who are listening have individual situations based on age, family or other personal considerations which require us to look carefully at your portfolio design. We know “one size doesn’t fit all.” We’re very happy to sit down and carefully examine your situation.

KR: In conclusion, please keep the following in mind, crisis and drama are big business for the media and they're not interested helping you maintain a disciplined long-term invest plan. They're interested in keeping you on the edge of your seat and tuned in to their station to hear the next "breaking news" story. Our country is strong and our economy is resilient. We will get through these current challenges as we have in every other past challenge we have faced.

On behalf of the Monitor Group, we are happy to have shared our thoughts with you today. Regardless of your review meeting cycle, please call us to set up a meeting or phone call to discuss your personal situation. Thank you.