

IN THIS ISSUE...

What Should You Do Now?
The Current Situation in a Nutshell
How Time Helps Manage Risk
Now What?
Are Your Investments Protected?
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WHAT SHOULD YOU DO NOW?

If you're not sure what to do in the current market situation, you're not alone. Investors around the world have been battered recently, as the crisis in the U.S. housing market took on broader implications.

On September 29, following defeat of the bailout legislation by Congress, the Dow Jones Industrial Average posted a record 778-point loss, making a cumulative 27% decline since reaching its highest all-time closing on October 9, 2007.

Over that same period, the Standard & Poor's 500 was down 29.8%, and the Nasdaq Composite shed 30.7%. Even when the Emergency Economic Stabilization Act was later passed on October 3, the markets were down sharply, on fears that this bill wouldn't avert a severe recession.

THE CURRENT SITUATION IN A NUTSHELL

It all started in the early to mid-2000s, when historically low interest rates, which were part of the Federal Reserve's response to stock market declines and threats of recession, caused the housing market to start booming. Until the mid-2000s, loans were based on fairly stringent standards.

But as the housing boom got underway, everyone seemed to think that there was no way to lose in this market. It became easier and easier to get a mortgage. Homeowners often could obtain adjustable-rate mortgages with low initial interest rates that would adjust after a certain number of years. No one worried how the homeowner, who could barely afford the current payment, would be able to afford a higher mortgage payment when interest rates rose. After all, housing prices were rising so rapidly that the lender could just sell the house, if needed. Lending standards became looser, with more and more subprime mortgages issued.

All of those mortgages, including

subprime, were bundled and sold as mortgage-backed securities and collateralized debt obligations (CDOs). CDOs divided a group of subprime mortgages into different lower-risk and higher-risk segments, called tranches. Each segment was sold separately and traded in secondary, over-the-counter markets. It was not uncommon for 80% of the subprime debt to be resold to institutional investors as an investment-grade security. To increase the credit rating, insurance policies were purchased guaranteeing repayment to investors. The companies issuing the insurance assumed that default rates would be minimal.

Eventually, the housing market began to stall, causing problems for many homeowners. The Federal Reserve started raising interest rates, causing many adjustable-rate mortgages to reset at much higher interest rates. Now finding that they owed more than the home was worth, many homeowners were unable to refinance when their interest rates

The questions on everyone's minds are: Just how bad are the markets and the economy going to get? What should we do about it? Is it time to sell every stock we own, withdraw all of our money from banks, and bury everything in the backyard? Or are we really looking at an opportunity to purchase stocks at low prices?

NO ONE KNOWS WHERE THE BOTTOM IS

The truth of the matter is that no one, anywhere, knows for certain where the economy or stock market is headed. But emotion is often an investor's worst enemy, both on the way up and on the way down. The last stages of a bull market are often led by investors desperate to join the crowd and make fast money, often entering the market just as it is peaking. Conversely, the last stages of a bear market are often marked by losses as investors finally give up, selling stocks for fear of future declines.

The way to overcome these emotions is to think calmly and

CONTINUED ON PAGE 3

CONTINUED ON PAGE 2

CURRENT SITUATION

CONTINUED FROM PAGE 1

began to adjust, causing a wave of foreclosures. Other homeowners didn't see much point in struggling to make mortgage payments on homes they had no equity in.

Noting the increasing default rates, rating agencies that had originally given CDOs and mortgage-based securities investment-grade ratings started to lower those ratings. Although values were known to be decreasing, no one knew how much these securities were worth or could find buyers to purchase them. This put increasing pressure on the debt markets.

Banks and investment companies are required to "mark to market" the value of their assets, meaning those assets should be valued at market value. This required huge write-offs on these investments. Reduced asset values on their books resulted in fewer reserves, causing liquidity problems. Some investment firms were especially vulnerable, since they had borrowed extensively to purchase investments in mortgage-based securities and CDOs. For instance, Lehman Brothers had \$30 of borrowed money for every \$1 of its own money invested in these securities.

Investors became alarmed by the huge write-offs and decreased reserves, selling shares in these companies. Banks, which typically loan money to each other overnight to help meet reserve requirements, stopped making those loans, because they were concerned about the collateral at the banks they were lending to.

These circumstances led to the downfall of several financial institutions. Some financial institutions — Countrywide, IndyMac, Fannie Mae and Freddie Mac, AIG, Washington Mutual, and Wachovia — got into trouble because they were heavily involved in originating or guarantee-

NOW WHAT?

Officially called the Emergency Economic Stabilization Act, Congress finally passed the \$700 billion bailout package on October 3, which was signed into law by the president on the same day. It establishes the Troubled Asset Relief Program (TARP), which will allow the U.S. Treasury to use its balance sheet to purchase troubled mortgage investments from banks and financial institutions. While these troubled investments may eventually recover in price, helping to reduce the overall cost of this bailout, that won't be known for years.

The exact details of how this program will operate haven't been worked out yet, but it is expected that the U.S. Treasury will use a reverse auction to purchase these securities. In a reverse auction, sellers indicate how much they are willing to accept to sell their securities. The government then purchases those being offered at lower sales prices, helping to ensure that they don't overpay for these securities. Once those assets are off the financial institutions' books, it is hoped that financial institutions will start lending again with the cash they receive for those investments.

As part of the legislation, the Securities and Exchange Commission (SEC), the Federal Reserve, and the U.S. Treasury must study the impact of the "mark to market" rule and report to Congress in 90 days. The SEC commissioner will have the authority to suspend the rule or ease its application, possibly allowing firms to estimate values of these securities based on expectations of future cash flows and an appropriate risk premium. This will reduce write-offs on mortgage investments, which will help resolve financial institutions' liquidity problems.

The legislation also contained several other provisions, including increasing government insurance on bank deposits from \$100,000 to \$250,000, allowing the government to use warrants to obtain equity interests in companies, limiting excessive executive compensation at some companies, and allowing federal agencies to modify troubled mortgage loans.

Will this legislation cure the problems ailing the financial system? We are in unprecedented territory, so no one knows for sure. ○○○

ing mortgages that ended up with much higher rates of default than anyone expected. Other institutions — Bear Stearns, Lehman Brothers, and Merrill Lynch — got into trouble due to their investments in mortgages.

Next, lending started to freeze up. The federal government tried numerous things to help the situation, including lowering interest rates, pouring billions of dollars into the economy to help keep financial institutions afloat, rescuing Fannie Mae and Freddie Mac, investing in

AIG, and putting deals together for the takeover of several firms. Unfortunately, nothing seemed to help.

Finally, the government went to Congress asking for \$700 billion so they could put together a more structured approach to helping the financial institutions. Although Congress initially vetoed the plan, it was passed on October 3 and signed into law by the president on the same day. See the article "Now What?" for more details of this legislation. ○○○

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ARE YOUR INVESTMENTS PROTECTED?

With all of the recent problems in the financial sector, it's probably a good idea to review how your assets are protected.

BANK ACCOUNTS

The Federal Deposit Insurance Corporation (FDIC) is an independent agency of the United States government, protecting consumers against loss of deposits when an FDIC-insured bank or savings association fails. FDIC insurance is backed by the full faith and credit of the U.S. government. Your bank accounts, including checking, savings, and money-market accounts, are insured for a maximum of \$250,000 at each bank, which was just raised from \$100,000 as part of the bailout legislation. Retirement accounts are also insured up to \$250,000. Each co-owner of an account receives the maximum coverage. So, a married couple with a joint checking account would be insured up to \$500,000 for that account.

Retirement accounts include traditional and Roth individual retirement accounts (IRAs), self-directed Keogh accounts, 457 plan accounts for government employees, and employer-sponsored defined-contribution plans that are self-directed.

Checking accounts, negotiable orders of withdrawal (NOW) accounts, money market savings, savings accounts, and certificates of deposit are covered by FDIC insurance. Stocks, bonds, mutual funds, investments backed by the U.S. government, contents of safe deposit boxes, losses due to fraud or theft at the institutions, and insurance and annuity products are not covered by FDIC insurance.

Even though coverage for retirement accounts is set at \$250,000, make sure your particular investments are covered by the insurance. If you hold stocks and bonds in a retirement account with your bank, those assets are not protected by FDIC insurance.

If your general or retirement

accounts are in excess of the FDIC limits, you can set up accounts with different categories of legal ownership, which are insured separately. For instance, a married couple might have separate accounts as well as a joint account, each with its own coverage. The other alternative is to move some of your accounts to another bank.

BROKERAGE ACCOUNTS

The Securities Investor Protection Corporation (SIPC) is an organization created by the federal government with the objective of promoting public confidence in the securities markets. The SIPC insures investors against losses arising from the financial failure of a brokerage firm.

All brokers and dealers registered with the Securities and Exchange Commission (SEC) and all members of national securities exchanges must be members of the SIPC. Firms that deal exclusively in mutual funds, variable annuities, or U.S. government securities are not required to be members. Member firms provide the funding for the SIPC, although in emergencies, the SIPC can borrow from the U.S. Treasury.

While the SIPC does not protect investors from losses caused by fluctuations in market value, it does protect investors from losses due to a member's financial failure. Once a firm fails, all securities registered in customers' names are returned to those customers. Brokerage firms must follow strict guidelines for segregating customer investments from

the company's assets. After that, customers receive, on a pro-rata basis, all remaining cash and securities held by the firm. SIPC funds are then used to satisfy all remaining claims of customers, up to a maximum of \$500,000 (up to \$100,000 of this total is available for cash balances). These limits do not apply to any investments the customer has already received back, only for investments that have not been returned. If an investor has claims beyond the SIPC's coverage, he/she becomes a general creditor of the failed firm. These maximum limits apply to each separate account. Therefore, where a customer holds several accounts in different capacities, each account would be eligible for this coverage. For instance, an investor with one account solely in his/her name and another with his/her spouse would be considered two separate accounts. However, two separate accounts registered solely in one name would be considered one account.

Securities covered by SIPC insurance include cash balances, notes, stocks, bonds, mutual funds, debentures, certificates of deposit, warrants, options, and registered limited partnerships. Shares of money market funds, while commonly considered cash by investors, are classified as securities and subject to the higher \$500,000 limit. Unregistered investment contracts and gold, silver, or other commodity contracts are not protected.

Many brokers also obtain additional coverage through commercial lenders. ○○○

PLEASE CALL

During these very volatile and unprecedented times, it may seem difficult to remain committed to your investment strategy. You're not in this alone. If you'd like to review your portfolio, gain further perspective on recent events, or discuss what's going on, please call. ○○○

Rick