



Investment Update

Fischer Investment Group, Inc.

Good Riddance 2008

Quite certainly, 2008 was a traumatic year. The financial crisis took a dramatic toll on our banking system, American home prices declined more steeply than at any point since the Great Depression, there were scary movements in the price of oil and other commodities, and the world witnessed food riots in developing countries. 2008 marked the worst year for the equity markets in decades. The Dow Jones Industrial Average had its worst 12-month performance since 1931. But beyond banking and housing, parts of the American and European economies delivered decent economic growth. Despite the catastrophic turmoil in finance and the sharp downward turn in the latter part of 2008, global economic GDP growth was still around 3.8%. Not nearly as bad as most had feared.

Years of easy money moved financial institutions to extend loans to individuals and businesses that were credit risks. The result was excessive leverage caused by overconfidence in new asset securitization investment products. The combination of record low interest rates and loose lending standards allowed millions of formerly non-qualified homebuyers to buy real estate. Demand pushed prices higher and builders got busy. Those who already owned homes refinanced, and others opened home equity lines of credit.

But in 2008, the real estate market cooled and interest rates rose slightly, triggering ARMs to reset at higher rates. Borrowers began to default and foreclosures began to rise. As a result, mortgage lenders found themselves without a secondary market for their bundled loans, and they couldn't raise capital. When government sponsored enterprises like the Federal National Mortgage Association, better known as Fannie Mae, and the Federal Home Loan Mortgage Corporation, better known as Freddie Mac, lost more than 2% of their collateral, it wasn't good news.

On Wall Street, financial institutions bought and packaged (and repackaged) risky debt, borrowed more money, and designed new financial products laced with subprime and adjustable rate mortgages (ARMs). These institutions used legal but less than transparent bookkeeping methods to ensure their AAA, or excellent, credit ratings—even though they had risky debt on their books. Such ratings allowed entities like commercial banks and pension funds to invest in these emerging financial products.

Financial institutions had help getting into this mess. Public policy over the last two decades encouraged excessive leverage. In the mid-1990s, then President Clinton attempted to increase home ownership by pushing his National Homeownership Strategy. President Bush signed into law the American Dream Down Payment Act of 2003 and offered tax credits in an effort to increase minority homeownership.

Back on Wall Street, government regulations couldn't keep up with or reign in the financial innovation and engineering. The roots of that innovation gap can be traced to 1987 and the

reinterpretation of the Glass-Steagall Act, a move that then Federal Reserve Chairman Paul Volcker opposed.

Adding fuel to the fire is “fair value accounting.” It has made a very bad situation much worse by causing an asset's fair value to fall when the market falls. These losses are reflected on corporate balance sheets, causing a further downward pull on a company's stock.

The U.S. far outspends what it earns and other countries finance that deficit. The U.S. Gross National Debt topped \$10 trillion this year and, going forward, the government sector still faces huge spending in terms of social security, Medicare and stimulus packages from the Obama administration. U.S. individuals didn't fare much better than their government. As of June 2008, consumer debt, which does not include debt secured by real estate, stood at \$2.6 trillion dollars, more than \$8,500 for every man, woman and child who lives in the U.S.

An increase in consumer saving is the wise choice for the long run, but consumer spending makes up nearly three quarters of the U.S. economy. When consumers save, they don't spend as much, and the market contracts. When consumers drop their spending, it leads to a drop in GDP and is a signal that the economy is in trouble. The classical economic approach would be to let the contraction occur and the market adjust, but for several decades, the government “protected” financial markets by keeping interest rates low. These actions may just be postponing more pain.

As it is, the pain is bad enough. Unemployment hit 7.6% in January 2009 with job losses for the month reaching 598,000. This doesn't bode well for the economy as a whole and is something most consumers will be frightened about. It appears that the biggest increases in unemployment will be in the construction, manufacturing and retail sectors.

Looking ahead to 2009

Unfortunately, it does not appear that the global economy will be able to match the global economic GDP growth of 2008. For

Glass-Steagall Act of 1933: The Glass-Steagall Act of 1933 established the Federal Deposit Insurance Corporation (FDIC) in the United States and included banking reforms, some of which were designed to control speculation. The banking industry had been seeking the repeal of Glass-Steagall since at least the 1980s. In 1987, the Congressional Research Service prepared a report which explored the case for preserving Glass-Steagall and the case against preserving the act. Provisions that prohibit a bank holding company from owning other financial companies were repealed on November 12, 1999, by the Gramm-Leach-Bliley Act.

Fair Value Accounting: Fair value accounting is used as an estimate of the market value of an asset or liability for which a market price cannot be determined. This arises when there is no established market for an asset. This type of accounting is used for assets whose carrying value is based on mark-to-market valuations; for assets carried at historical cost, the fair value of the asset is not used.

small pockets of the economy conditions may get better but for most things it will continue to look bleak. Certain sectors, like investment banking and home building virtually ceased in 2008. This trend will continue into 2009 until home prices find a bottom in the spring or summer. This should at least stabilize the home building industry although a recovery is probably still a few years off.

Other sectors will also find 2009 to be much tougher than 2008. With the frozen credit markets and gloomy undertone to the overall economic outlook, non-financial companies are retrenching to weather the storm. Most US companies will continue to aggressively control costs causing increasing numbers of layoffs and forced spending cuts. This will cause economic growth to contract, resulting in rising unemployment and decreased consumer demand for everything from electronics to dining out.

Increased weakness in the overall economy will make it more and more challenging for businesses and consumers to service their debt obligations. Although default rates increased year-over-year from 2007 to 2008, we feel that the picture for 2009 will be much worse than 2008. This could trigger another wave of financial write-downs and frantic capital raising by the financial institutions. The increased pressures on commercial and retail banking will mean that the credit crunch will continue for much of 2009.

The theme for 2009 will predominantly be uncertainty and tattered confidence in the economy and markets. Investors will be far more risk averse for the better part of the year, allocating bigger positions to what are viewed as safe havens for their assets (US dollar, US Treasuries, Gold). The equity markets will continue to struggle in 2009. Central Banks around the world will go all out to combat the financial crisis with interest rates converging to zero in most major industrialized economies. These radical measures should ensure most economies avoid sustained deflation. At some point in 2009, investors will start to anticipate a recovery as the government bailouts, stimulus packages and rate cutting start to have an impact.

A weak consumer could limit the possibility of a sustained rally. Since personal consumption accounts for two-thirds of economic activity, a significant drop in consumer spending habits like we saw in the third quarter of '08 could significantly affect the economy. If US consumers do end up spending considerably less in the coming years, corporate profits will have a difficult time returning to their pre-2008 strength. That would mean that many seemingly "cheap" stocks could actually be fairly valued.

The cost of capital should be very high for an extended period of time. Buyers of homes, cars and securities are faced with much bigger collateral requirements than in the past. This will limit the ability of many small businesses to maintain profitability. On the trading side, banks and brokerage firms have been forced to conserve cash which leaves less capital available to support trading. This will mean wider spreads between the prices at which investors can buy and sell stocks or bonds. This could lower trading volumes, heighten volatility and diminish the desire for risk taking. Hopefully, 2009 will turn out to be a good year for the economy and we think it can if things align properly. If the credit markets start to loosen, housing prices stabilize, the economic slide abates and the

Obama administration structures its recovery plan well there is a good chance we could have some strong returns for 2009.

A strong recovery in 2009 is contingent on good public policy, which is an oxymoron.

Poor public policy is why we are in this mess starting with the repeal of the Glass-Steagall Act and the passing of the Gramm-Leach-Bliley Act. Our opinion is that infrastructure and defense spending are the keys to growth in the economy since they are 'Made in the USA.' It will be nearly impossible for us to reduce the trade deficit since we don't manufacture goods that the rest of the world wants.

Gramm-Leach-Bliley Act:
The Gramm-Leach-Bliley Act was enacted November 12, 1999, repealing part of the Glass Steagall Act of 1933. The Act allowed commercial and investment banks to consolidate forming bank holding companies. Many of the largest banks, brokerages, and insurance companies wanted the Act. The major reason was that these firms felt individuals usually put more money into investments when the economy is doing well, but they put most of their money into savings accounts when the economy turns bad. This new act would allow them to do both savings and investments at the same financial institution.

2009 is lining up to be the weakest year for the global economy since the aftermath of 9/11 and the dotcom bust of the early 2000's. With all this being said there is one thing to remember: it could be worse. Given the massive scale of the financial and housing crisis, and the commodity price shock we could have seen a repeat of the 1930's. The fact that we aren't speaks volumes for the actions of policymakers during 2008.

The strategy we implemented in late 2007 and early 2008, to shift from small and mid cap holdings to more stable, large cap companies paid off well. We were also able to find good value in the fixed income market through the purchase of strong investment grade corporate and municipal bond offerings. This allowed us to mitigate downside loss far better than our peers and the major indices.

Our strategy for 2009 will be very similar to that of 2008. We will continue to focus our research on finding stable, well-managed, dividend paying companies in sectors that have historically weathered severe market downturns well. Portfolios will have more concentrated equity positions (higher % of assets per holding) to prevent over diversification. On the fixed income side, we continue to find some strong offerings in both the investment grade corporate and municipal bond markets with varying maturities usually in the range of 4 to 10 years. Although fixed income inventories have certainly contracted we have still been able to uncover some decent offerings. Lastly, during market downturns we feel it is prudent to hold more cash in accounts than normal. It is not unusual to see 10-20% cash in your account. As always, we would like to thank you for your business and continued confidence in our approach. We hope you all have a healthy and prosperous 2009.



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