



Update Regarding the Financial Markets

A SPECIAL REPORT September 19, 2008

Note: The following special update was updated Friday at noon, Sept. 19th. It went through more than a dozen drafts; revisions were required to reflect new information. Because events are continuing to develop with unprecedented speed, the following information could be outdated by the time you read it. Therefore, we will issue updated information as warranted.

Lehman Brothers, 158 years old and the nation's fourth largest brokerage firm, has filed for bankruptcy, with the bulk of its assets purchased by Barclays, a British company. The nation's largest brokerage, 94-year-old Merrill Lynch, is now gone, too, having been acquired by Bank of America (although BofA says it will continue to use the Merrill name). AIG, until recently the largest insurance company on the planet, has been taken over by the federal government. All this follows the demise of Bear Stearns, the nation's 5th largest investment bank, having been acquired by JP Morgan Chase in a government-supported takeover. And Fannie Mae and Freddie Mac have been nationalized; taxpayers now own 80% of those firms.

Two words come to mind regarding all these firms: **comeuppance** and **good riddance**.

Okay, that's three words.

I feel like Stanley shaking his head while muttering to Ollie, "Well, here's another nice mess you've got me into." Many have noted the following: that we are in a recession; that home values have declined an average of 20% since 2006, according to the S&P Case Shiller Index, and are still dropping; that 6.4% of homeowners with mortgages are behind on their payments and 2.75% are in foreclosure, according to the Mortgage Bankers Association; that unemployment nationally is 6.1%, according to the Bureau of Labor Statistics; that oil prices recently hit an all-time high of \$145/barrel, as have gold prices, at \$1,002.95/ounce, according to *The Wall Street Journal*; that the dollar has fallen to an all time-low against the Euro, at

\$1.60, also according to the *WSJ*; that more than a dozen banks have failed, including Indy Mac (the 2nd largest bank failure in U.S. history) and that the FDIC says 117 more banks are on its problem list; that the personal savings rate is near its all-time low, according to the Federal Reserve; and that the stock market has fallen more than 20% from its highs of nearly one year ago, with many mutual funds and other investments faring far worse.

And it's Merrill's fault. And Lehman's and Bear Stearns' and AIG's (and some others, too). Fannie and Freddie are culprits as well, as is the entire mortgage industry. Add the real estate industry while you're at it, including appraisers and home builders. And don't stop there. Congress is also to blame — from former House Speaker Newt Gingrich to current speaker Nancy Pelosi and everyone in between. Also Bill Clinton and Alan Greenspan, as well as George Bush.

The Wall Street brokerages and investment banks, with the encouragement of federal policy makers, have flooded America with cash. And to get that cash into society, lending rules were loosened so that virtually anyone could get a loan. When your parents bought their house, they were required to make a down payment of at least 20% and prove they had sufficient income and assets to afford a mortgage loan. They had to pay prevailing interest rates (usually in the neighborhood of 6%), too. But home buyers in the late 1990s and early 2000s suffered no such hassles.

Because presidents love to brag that more people own homes than ever before, and because Congress ►

loves the revenue generated by a growing economy, the rules were loosened. As a result, you could now buy a home with no money down — even the loan's closing costs could be financed. The initial payment could be based solely on a 1.25% interest rate, even though that rate was not the loan's real rate. If you couldn't afford even that, you could simply pay a smaller amount of your own choosing. And if you still couldn't afford it, well, no one would know because lenders were willing to grant you a loan without verifying that you had any income or assets at all. Loan officers started calling these mortgages "liar loans."

By 2003, it took less cash to buy a house than to rent an apartment, and the monthly payments were lower, too. It's no wonder that, year after year, home ownership reached a new all-time high, just as the politicians wanted.

With so many people flocking to these new, enticing loan products, lenders needed lots of capital to meet demand. After all, if a bank has \$300,000 on hand, it can only lend that money once. So it needs to replenish that cash. Unable to attract enough CD deposits, lenders turned to Wall Street for help.

And our nation's biggest brokerages were only too happy to help.

The big brokerage firms bought the loans from the banks and packaged them into pools. They then split the pools into pieces ("tranches" in Wall Street parlance) and sold each tranche to investors. Pension funds, endowments, hedge funds and mutual funds scarfed them up. Some of the pools held low-risk loans; these consisted of borrowers who made 20% down payments on traditional 30-year 6% fixed-rate mortgages. But other tranches consisted of the new "subprime" or "Alt-A" mortgages — obtained by borrowers who managed to borrow more than the house was worth, paying less than the monthly payment and with little or no assets or income that might enable them to keep doing so. But on paper, the loans were profitable, and Wall Street found them easy to sell to investors eager for the high returns that had been eluding them since the dot-com bubble had burst in 2000. And to give the illusion of safety, firms creating these securities had them insured.

Enter AIG and other insurance companies. In exchange for a premium, AIG agreed to guarantee these

investments in one way or another. Now, with Lehman's collapse, it appears that those promises might need to be honored. There are fears that AIG might not be able to pay all those claims.

So there you have it. Wall Street invented newfangled investment products (including collateralized debt obligations, constant proportion debt obligations, structured investment vehicles and more). Being new and untested, no one could say exactly how these investments would perform, but insurance companies guaranteed them, enabling Wall Street to offer rosy scenarios. The insurers got rich selling policies with fat premiums, brokerages got rich selling new securities, lenders got rich selling more loans than ever, builders, real estate agents, title settlement companies, appraisers, inspectors — everyone got rich from the ensuing real estate boom. The only ones who didn't get immediate profits were the borrowers, who hoped the houses they were buying would rise in value, and the investors, who hoped their investments would be profitable.

Now that the mortgage and real estate markets have dropped, those investments — and their guarantees — are being tested. One example is the disaster that's hit investors of Auction-Rate Securities. These products were touted as being as safe and liquid as money market funds but with higher returns. But as millions of hapless investors now know, those securities have proven to be anything but safe and liquid. Merrill Lynch has been forced to repay \$4 billion to investors to whom it sold these products; Wachovia is refunding \$9 billion; Fidelity is repaying \$300 million; and Bank of America is coughing up \$4.8 billion. This doesn't include fines and penalties, some of which haven't yet been assessed, or further settlements with additional brokerage firms. And all this is just pertaining to one small segment of the derivatives market. We haven't even talked about the problems that have just now hit money market funds. (But we're getting ahead of the story.)

It's all an amazing cycle, really. People desperate to buy a house found banks happy to lend them money, using cash provided by Wall Street investment banks (a.k.a. brokerage firms), which had raised the cash by buying the loans, packaging them into investments, getting insurers to guarantee them, and then selling the investments to

investors — many of which included retail mutual funds, whose shares are often owned by the very people who were now requesting the loans. It's an amazing cycle indeed.

As more and more loans were obtained, builders constructed more houses, real estate agents hawked the properties, and prices rose — often quickly and dramatically.

Of course, this game had to come to an end. Borrowers who were paying less than the interest cost each month were told not to worry. They were told that after three years or so, when payments would have to begin at the full amortized rate, they'd be able to refinance the loan or sell the house. Either will be easy, the borrowers were told, because the house will rise in value and interest rates will drop.

But we know what happened instead. Interest rates didn't fall; they rose. And home prices didn't rise; they fell. As a result, borrowers who had signed up for these new-fangled loans found themselves suddenly facing monthly payments that were as much as three times higher than previous payments. Unable to pay and unable to sell the house for as much as they owed the bank, 2.75% of the nation's homeowners who have mortgages have defaulted, according to the Mortgage Bankers Association, with many of them losing their homes and helping to lower housing prices even more.

And what of the banks and brokerage firms that helped to fuel all this? Well, Indy Mac Bank, the nation's 7th largest seller of subprime mortgages, is gone. It failed in July and was taken over by FDIC. Fannie Mae and Freddie Mac are now essentially government agencies. Merrill Lynch is history, too, having been gobbled up this week by Bank of America. Bear Stearns was similarly acquired by JP Morgan Chase. After filing for bankruptcy, Lehman Brothers was purchased by Barclays, and AIG is now 80% government-owned.

These institutions earned huge profits by foisting their wares on a largely unsuspecting public that is now stuck with the mess they've left behind. And the current mortgage mess isn't the first time these Wall Street firms have done this to us — it's merely the latest chapter. In 2003, 10 major Wall Street firms — including Merrill Lynch, Lehman Brothers and Bear Stearns — were fined \$1.4 billion for issuing misleading recommendations about Internet stocks.

You might think the firms would have learned a lesson. Well, maybe they did: With \$23.9 billion in employee bonuses paid in 2006, executives at those firms may well have concluded that such behavior is justified.

So, all we can say is that these firms have finally gotten their comeuppance. Now they're gone, and we say good riddance. By that, I refer to their boards and CEOs. Our hearts go out to the many tens of thousands of employees whose jobs are now at dire risk, along with their pensions, retirement plans and stock option programs.

But where does this leave us? Although we are relieved that these firms will do investors no more harm, their demise does us little actual good. We need to focus on the future.

What will happen next? This could be the most dramatic chapter in Wall Street's 216-year history. What does it mean for you and your investments?

Our reply might surprise you. To state it succinctly, we are more excited than we have been in years. We consider events of the past several days — in fact, the past few months — to be exhilarating. Here's why:

- **Lehman Brother's demise was perfectly executed.**

Treasury Secretary Henry Paulson has thus far done an outstanding job, and we applaud each of his actions to date. He was right to orchestrate a bailout of Bear Stearns; at the time, its surprising collapse could have led to a panic on Wall Street. To prevent that, he convinced Chase to buy the firm by agreeing to have the government pay for losses caused by Bear's derivative business. He and other officials were also right to take over 'Mac and 'Mae, tossing out both CEOs in the process, even though the move may cost taxpayers billions of dollars. But when he refused to let taxpayers back Lehman's losses, no bank or brokerage was willing to buy the firm. So be it, Paulson decided: let Lehman fail. He sent a crucial message to the rest of Wall Street: you are on your own; the Government of the United States cannot be relied upon to bail you out of the troubles you've caused yourself. That realization, many say, is what led Merrill to agree so quickly to BofA's takeover offer, which occurred without any government guarantees. Paulson is no fool; he knows the Street well, having served as chairman and CEO of Goldman Sachs before becoming Treasury's secretary.

- **Further destruction is likely to come to Wall Street, but we don't believe that to be a long-term problem for Main Street.** Americans will watch with astonishment, just as we do the California wildfires, but we'll watch safely from a distance. Little harm will come to ordinary Americans or their investments. Want proof? Consider the following:
 - **The 504-point decline of the Dow Jones Industrial Average¹ on Monday seemed to be a negative response to the weekend's news about Lehman, Merrill and AIG, but look closer.** Although AIG's stock fell 60% on Monday, 20 of the 30 Dow stocks fell less than 5%. Investors figured this out, and as a result the Dow jumped 142 points on Tuesday. The Dow posted further dramatic gains on Thursday and at this writing is doing so again on Friday.
 - **That 504-point decline wasn't as big as it seems.** Consider that 500 points isn't even close to hitting the triggers that were put into place after the Crash of 1987; the Dow would have had to decline 1,350 points for the market to be halted for an hour. In fact, on a percentage basis, Monday's drop was merely the 96th biggest drop in the Dow's history, according to Dow Jones & Company. The fact that it wasn't worse is actually good news, for it shows that investors haven't panicked;
 - **The Dow could rise as it removes AIG from the index and replaces it with Kraft Foods.** A rose is a rose, Shakespeare said, but he wasn't an investor. The Dow consists of 30 stocks, and replacing a bad financial stock with a recession-resistant company is likely to have notable effect on the index's performance. "Mac and Mae" is out; "Mac and Cheese" is in! Few will notice the window-dressing, but everyone will notice the uptick in the performance;
 - **Claims that the nation is in recession are false.** Recession occurs when we have two consecutive quarters of declining Gross Domestic Product. But in the second quarter, GDP didn't decline — it grew 3.3%. That's pretty much the same as it's grown every quarter, on average, since 1926, according to the Treasury Department;
- **There is still a huge amount of home equity in the U.S.** — \$9.65 trillion, according to the Federal Reserve. That's down very little from the \$9.93 trillion figure in 2007;
- **While 6.4% of homeowners with mortgages are behind on their payments and 2.75% are in foreclosure, this is nothing compared to the Depression, when 50% of all homes were in default,** according to the Federal Reserve. Furthermore, most foreclosures are occurring among homeowners who obtained subprime mortgages. People who signed up for liar loans comprise only 12% of all mortgages but 52% of all foreclosures, according to the Mortgage Bankers Association;
- **The total default rate this year is about the same as it was in 1985,** according to MBA. Furthermore, home prices are falling most in the markets where prices had risen the greatest — places such as Florida, California, Arizona and Nevada. And many of those homes were purchased by investors hoping to get rich quick by flipping their purchases before they had to make many mortgage payments. It got to the point that many cities passed laws prohibiting investors from buying properties because they were causing prices to rise too much. In these communities, the people losing properties are not American families but real estate speculators;
- **Although the nation's unemployment rate is 6.1%, that's a far cry from the 25% we experienced in the 1930s;**
- **Oil prices are no longer at their high of \$145/barrel; they've fallen 36% to \$92/barrel.** Ditto for gold prices, which are currently \$782/ounce — down 22% from its high;
- **The dollar, too, has rallied,** as U.S. exports have increased. It is now \$1.41 to the Euro compared to \$1.60 just 5 months ago;
- **As for the fact that a dozen banks have failed in 2008, well, that's nothing compared to the 832 that failed in the 1991-1992 recession, according to FDIC.** Although more than 100 banks are on its prob-

¹An index is a portfolio of specific securities (common examples are the S&P, DJIA, NASDAQ), the performance of which is often used as a benchmark in judging the relative performance of certain asset classes. Indexes are unmanaged portfolios and investors cannot invest directly in an index. Past performance does not guarantee future results.

lem list, FDIC says few will fail — and the bulk of the 8,500 U.S. banks remain in strong financial condition;

- **The personal savings rate this year is better than it was in 1999**, according to the Federal Reserve; and
- **Only six years ago, the Dow was 7700.** It had fallen 45% over three years. Do we really want to complain that the stock market has fallen about 20% from last October's high, or do we want to instead remember that the Dow is still nearly 50% higher than it was six years ago?

This time *isn't* different!

Too often, after explaining why we're not panicking and why we're downright enthusiastic about the future, we hear that age-old refrain, "*But this time it's different!*"

No, it isn't. Government bailouts and takeovers are nothing new. In 1971, Richard Nixon rescued Lockheed by providing \$250 million in loan guarantees. When the Penn Central Railroad failed in 1971, Nixon created Amtrak. Jimmy Carter gave \$1.5 billion in loan guarantees to Chrysler in 1979. Under Ronald Reagan, the FDIC in 1984 spent \$4.5 billion to rescue Continental Illinois, which still holds the record as the largest U.S. bank failure. Then, during the S&L crisis of the 1980s, George H. W. Bush approved the bailout of 747 savings and loans at a cost to taxpayers of \$124.6 billion. In 1998, under Bill Clinton, the Federal Reserve Bank of New York bailed out Long Term Capital Management at a cost of \$3.6 billion. During the Mexican Peso Crisis, Clinton arranged for loans and guarantees to Mexico totaling almost \$50 billion. Then, following the September 11, 2001, terrorist attacks, George W. Bush approved \$15 billion in subsidies and loan guarantees to aid the faltering airline industry.

This year, the Federal Reserve approved a \$30 billion credit line to help JP Morgan Chase acquire Bear Stearns and engineered takeovers of Freddie Mac, Fannie Mae and AIG. The names, dates and amounts are different, but that's about it.

This time isn't different. Except maybe in attitudes. Former Senator Phil Gramm made headlines this year when he claimed we're in a "mental recession." His point was drowned out by his next comment — that we're a nation of whiners — but his first statement does indeed make sense: In the heat of the moment, it is indeed easy to create broad conclusions from momentary data. That's how people often make bad investment decisions.

Our goal is to help you through periods like this, to help you enjoy long-term prosperity. We know, and we hope you realize as well, that it's easy to make money in good times. The trick is in learning how to survive bad times. You do this by avoiding large losses, positioning yourself to earn the potential profits when they return (and, they always return eventually).

Some of your money, of course, is not invested for the purpose of generating profits. Instead, the goal is safety and liquidity. For that portion of your assets, you may use money market funds, and you should take great care to confirm that the money market funds you use are safe, such as those that invest solely in U.S. Government Securities or investments protected by SIPC. After the markets closed on Tuesday, The Reserve Fund announced that one of its money market funds, the Primary Fund, "broke the buck," meaning its share price dropped below \$1, something that hasn't happened to any money market fund in 14 years. The cause: the Primary Fund held \$785 million of debt securities issued by Lehman Brothers — securities the Reserve Fund has now valued as zero. As a result, the Primary Fund's share price is now just 97 cents, a 3% decline in value. Worse, it is suspending liquidations for seven days, prohibiting investors from making withdrawals.

The Primary Fund broke the buck and others may follow. But some are being rescued by their corporate parents. For example, Evergreen's three money market funds collectively hold nearly \$500 million, or 1.9% of its assets, in Lehman credit issues. Those securities are now probably worthless. But rather than break the buck, Evergreen's parent, Wachovia announced on Tuesday that it will purchase those securities, ensuring that the funds continue to post a \$1 share price. On Wednesday, Bank of America (which holds \$400 million in Lehman paper) and SunTrust (\$70 million) made similar announcements. Will other corporate parents come to the rescue of their subsidiaries' money market funds? What happens if they choose not to do so? Will Paulson's new plan, introduced just a few hours ago as I write this, solve the problem? Will Geraldine tell Alfred that she's pregnant with Harvey's baby? Stay tuned for continuing developments in what is clearly the most astonishing soap opera ever displayed by the financial markets.

While the financial stability of firms like Merrill Lynch, Bear Stearns, Lehman Brothers are making headlines, remember that not every financial company faces dire straits. Many are quite safe and healthy. For instance, we place all our clients' assets at TD Ameritrade or Pershing, two of the largest custodians in the industry. **In response to this week's events, both TDA and Pershing have issued statements affirming that our client accounts are secure.** TDA announced that its capital structure and liquidity are "strong and stable" and that it has "no exposure to the U.S. real estate market and the associated complex financial securities that are at the root of this liquidity crisis." Pershing has made similar announcements, reporting that it is well capitalized with capital ratios that exceed those required by regulators. Like TDA, Pershing does not originate, underwrite, or proprietarily trade subprime securities, collateralized debt obligations, or mortgage-backed securities and is not a retail mortgage underwriter or residential lender. Its parent firm, The Bank of New York Mellon, has a market capitalization of \$46 billion as of September 12 and more than \$23 trillion in assets under custody. Like its Pershing subsidiary, BNY Mellon does not underwrite or warehouse subprime securities or collateralized debt obligations.

Also, Sanders Morris Harris Group, which acquired Edelman Financial Services in 2005, released a statement this week saying that the firm "is in superb financial condition. The company has no funded debt and continues to operate profitably. Its primary revenue source is asset/wealth management, and as such is impacted only marginally by the turmoil in the bond and stock markets." And of course, Edelman Financial² is in outstanding financial condition as well.

So there is no need to worry about the firms involved with managing or maintaining our accounts. Instead, let's focus on the performance of those accounts. Here, too, the results are reassuring.

As of this writing, our typical client's account is down considerably less than the S&P 500 Stock Index, which is down 17.5% this year, and our client accounts are also down far less than the horrific, and perhaps permanent,

losses suffered by people who invested in shares of Freddie Mac, Fannie Mae, Bear Stearns, Lehman Brothers, AIG, Merrill Lynch or any number of other investments. Oh, to be sure, those stocks are found in our clients' broadly diversified holdings. But for most of our clients, the *total* combined weighting for all of those companies constitutes just 0.9464% of their portfolios.

That's quite a contrast from the investment practices of others. One retail mutual fund, for example, has 16.7% of its assets in AIG stock. That stock is now virtually worthless, causing substantial losses to people who own that fund.

And that mutual fund is not alone. Another has 7.11% of assets in AIG; a third fund's holdings of AIG totals 6.05%; and a fourth has invested 5.39%, as of the latest SEC filings. All told, according to Morningstar, 211 retail mutual funds have placed 3% or more of their assets into the stocks of Fannie Mae, Freddie Mac, Bear Stearns, Lehman Brothers, Merrill Lynch and/or AIG.

If you know someone who owns an investment that is down substantially more than the S&P 500, you can be pretty sure it's because that fund is being run by a manager who has been speculating by taking big positions in few stocks — stocks that have experienced massive declines. Consider one retail stock mutual fund that's been touted frequently by a certain radio talk show host (no, not me!) — it's down 30% so far this year. Many others he touts are down nearly as much. Did the people who bought those funds realize they were exposing themselves to such risks?

All this confirms what we've been saying for more than 20 years: Diversification works. It reduces risks and helps position you properly so you can enjoy the profits that are yet to come.

Best of all, diversification is only part of the story. Our strategic rebalancing enables us to capture short-term anomalies when they occur, and this helps to reduce volatility while securing incremental profits and helping you acquire additional shares at lower prices. Selling high, buying low! It's a great approach to dealing with turbulent financial markets.

²Edelman Financial is a marketing name for two affiliated registered investment advisers. Edelman Financial Services LLC primarily serves the Washington D.C. area; Edelman Financial Advisors LLC serves clients nationwide via its own advisers and unaffiliated registered investment advisers. Sanders Morris Harris Group (Ticker: SMHG) is majority owner of EFS. Ric Edelman is majority owner of EFA and minority owner of EFS.

This is why we are so excited about our current times. As difficult as they are, and as challenging as they may yet be, we believe in the lesson of history: Once we get through today's turmoil, profitability and prosperity are ahead. Long-term, diversified investors, like those invested in the Edelman Managed Asset Program®, are well positioned to enjoy that prosperity.

I said that we haven't been this excited in years. We know exactly the years of which we speak. We recall 1987, when the market crashed; 1994, when we last had a recession; and 2002, when the stock market finished its three-year decline. We believe we are similarly poised right now, and the lower the markets go — the greater the problems that develop — the higher the recovery when it finally occurs. It might take a while, even a long while, but that recovery will indeed occur. And we want you to enjoy every bit of it.

For the moment, don't be surprised if we hear some more bad news, and see some additional turmoil. All you need to do is be patient and confident as we approach the new decade.

Well, perhaps that's not *all* you need to do. Here are seven action steps you should take today:

- 1. Be prepared for money emergencies.** Eliminate credit card debt and build substantial cash reserves to get you through unexpected job loss, health issues or other family concerns. A home equity line of credit is no substitute for cash reserves.
- 2. Make sure you've provided for your family.** This means owning the proper amount and type of insurance — life, health, long-term care, disability, auto, home and liability.
- 3. Start or continue contributions to your retirement plan at work.** Invest in a highly diversified manner, and avoid the stock of your employer — advice employees at Fannie Mae, Freddie Mae, AIG, Lehman Brothers and Bear Stearns now wish they had followed.

- 4. Get a big mortgage.** Interest rates are declining — a happy side effect of economic weakness — so now's the time to convert home equity into a liquid resource.
- 5. Preserve your legacy.** Update your estate planning, and make sure your will, trust and other legal documents are current and complete.
- 6. Stay in touch.** Get a good advisor and keep him or her informed about how you're doing, and check in whenever you face an unusual financial situation. If you need a referral to a talented, experienced advisor you can trust, just visit RicEdelman.com
- 7. Be realistic.** Although we have many good reasons to be highly optimistic, there's no denying that our nation faces serious problems. Aside from the financial uncertainties of the moment, there's the war, along with threats of terrorism, bird flu and global warming. Fortunately, there's an even longer list of favorable developments, including innovations in medicine and health care, peace throughout much of the world, major advances in science and technology, adaption of the free market system by nations worldwide, and new, focused attention on the aforementioned problems. Attention leads to proposed solutions which leads to positive resolution — no one ever gets hit by a bus they see coming. Still, the road from here to there can be slow and choppy, with unexpected turns. Be realistic and, as stated earlier, be patient and confident.

As noted at the top of page one, developments are occurring with such astounding speed that we fear this entire letter might be outdated by the time you read it. It is conceivable (although unlikely) that developments could cause us to alter our strategy. If you have questions or would like to speak with a financial advisor, contact us at 888-PLAN-RIC.

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