



Investment Commentary
October, 2009

Almost 80 years ago, after the stock market crash of 1929 and the ensuing depression, Congress enacted the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Advisors Act of 1940.

The 1933 Act required companies to provide better information to investors. It was meant to prohibit misrepresentation and fraud (can you say Enron? MCI?)

The 1934 Act created the Securities and Exchange Commission and created new rules to govern the trading of securities in the secondary market. This was previously left up to the individual states but the Federal Government felt it could do a better job. This would become a trend.

The Investment Advisor Act of 1940 created new regulations for Investment Advisors. Apparently there was a problem back then with Investment Advisors who did not always act in the best interest of their clients (can you say Bernard Madoff?).

Since 1940, there haven't been any watershed events with regard to new regulations in the securities industry....until now. A lot has changed and the powers-that-be feel it is time to create some new regulations. Quite frankly, we don't disagree but also recognize that better enforcement of current

regulations might be a good approach as well.

[As an aside, I have a radical idea for the reduction of Ponzi Schemes....jail time for the victims. I know this sounds a little harsh but hear me out. If you are tempted to hand your money over to someone who promises you investment returns above and beyond what anyone else seems to be able to reasonably obtain....and it turns out he/she used your money to buy fancy cars and a private jet, you might be more reluctant to fork over your hard earned dollars for that "too good to be true" investment if you knew that, in addition to possibly losing your investment, you might spend a couple months in the pokey. You can blame the perpetrators all you want but most Ponzi Schemes don't happen without greedy, gullible investors. Just a thought.]

So the upshot of the sub-prime mortgage disaster, the derivatives disaster, the shadow banking sector disaster, the banking sector disaster, high unemployment, and the worst recession since the 1930's combined with a new administration is that we are going to have major new financial regulations. I'm proud to say the CFA Institute Centre for Financial Market Integrity has been an integral part of a new report titled "U.S. Financial Regulatory Reform: The Investors' Perspective". Together with the Council of Institutional

Investors, they created the "Investors' Working Group" (IWG). Headed by William H. Donaldson and Arthur Levitt, both former chairmen of the SEC, they have created a roadmap for new regulation. The IWG report includes the following suggestions (which I will not explain in detail because their suggestions may not be adopted and it might make my Investment Commentary excessively tedious:

Strengthen the existing federal regulators and have them acquire better knowledge and expertise of the industry. I think it is a given that the SEC is understaffed. However, merely adding more staff will not be an effective solution. They need to understand all facets of our industry.

Regulate Over The Counter Derivatives. Derivatives are investments that are based upon the value of a separate investment. It's kind of like betting on a football team instead of playing on it. I can buy shares of General Electric or I can purchase a derivative security that will appreciate if GE's stock appreciates. It's a little more complicated than that but without billions of dollars in derivative securities that went the wrong direction, Bear Stearns and Lehman brothers might still be competing with Goldman Sachs today.

Require all investment managers available to U.S. investors to register with the SEC as investment advisors and be subject to oversight. This seems like a no-brainer to us. It is primarily aimed at hedge funds who somehow have managed to avoid SEC oversight. It also requires investment advisors to adhere to fiduciary standards, another no-brainer.

Financial regulators should have the authority over "systemically significant non-banks". When the Federal Government decided they needed to loan \$87 billion to AIG to avoid financial Armageddon, it

became apparent that the failure of large "non-bank" institutions can be just as dangerous as the failure of large banks. These huge, non-bank financial institutions are relatively new in our economy and have previously not been subject to traditional banking regulations.

A new agency should be created to regulate consumer financial products, including mortgages. In addition, they suggest that mortgage originators should be required to retain a "meaningful" interest in the mortgages they originate. This might make the originators less likely to issue unsuitable mortgages.

There need to be alternative methods to the Ratings agencies. This is my personal favorite. You can blame a lot of people for the sub-prime mortgage crisis but the ratings agencies are at the top of my list. Bad mortgages were issued to unqualified home buyers and those bad mortgages were packaged with other bad mortgages and sold to investors. Investors (who are not blameless) bought these securities because they relied on the AAA, AA, and A ratings that these packages of bad mortgages were given by the ratings agencies. If these "investments" were rated CCC, they would have been difficult to sell. If they cannot be sold to investors, the mortgage companies have to stop issuing new bad mortgages.

Investors need better tools to hold managers and directors accountable for their actions. Although many publicly traded companies are well run, there have been several companies (particularly financial companies) which have officers and directors that view the assets of the company as their own personal playground. Their "warped sense of entitlement" is impressive. When determining the compensation of any employee, it needs to be remembered that the employee is being paid from assets

that belong to the shareholders....particularly when that employee is being paid \$100 million. What is even more disturbing is when that employee is being paid \$100 million after running the company into the ground.

We need to create a new independent entity called the Systemic Risk Oversight Board to supplement the functions of existing financial regulators. In the twenty-eight years I have been in the investment industry, there have been many large changes. At the risk of sounding really old, I must point out that, when I began my career at Kidder, Peabody, & Co. in 1981, the personal computer was not for sale, Microsoft did not trade publicly and the internet did not exist (for the general public). Today, billions of shares trade in seconds and new types of securities are being introduced all the time. Mortgages are bundled together and turned into securities and sold to investors. Credit Default Swaps are fairly new as well as many other derivative instruments. No one (at least no one in charge) was aware of the potential financial damage that could occur by large institutions exposing themselves to excessive positions in these new securities using massive amounts of leverage. We definitely need the functional equivalent of that stupid looking robot from "Lost in Space" saying, "Danger, danger....stand by to repel boarders!" (definitely dating myself)

We don't know what new financial regulations the Obama Administration will ultimately enact (the Administration has its own proposals which are somewhat similar to those proposed by the IWG). Rest assured, however, that some sort of new regulation will be enacted.

From the lows recorded on March 9th through the end of September, the Dow Jones Industrial Average has increased almost 50% and the S&P 500 more than 50%. However, both indexes are still down around 30% from the stock market peak in October, 2007.

We have had a strong rally and several pundits are declaring the recession "over". It may be over but we think it is going to be a long time before the economy begins to feel like it is over. Reasons to believe it is over:

- The Institute for Supply Management Index jumped from 43.4 in July to 50 in August, an indication that business activity is gathering steam.
- U.S. non-farm productivity jumped 6.6% in the second quarter (although the negative spin on this statistic is that we are asking fewer people to do more work at a faster pace).
- Industrial orders in Germany increased 3.5% in July after increasing 3.8% in June.
- U.S. consumer credit declined for the sixth straight month in July.
- China's economy grew by 14.9% in the second quarter.
- Initial unemployment claims fell for three straight weeks in September.
- The stock market rally makes many people think the recession is over.

Reasons to still be concerned:

- There were 358,471 new home foreclosure filings in August, close to the record set in July and an 18% increase over August, 2008. Between now and 2011, another \$189 billion of Option ARM mortgages will re-set, most of which will have a difficult time avoiding foreclosure.
- Falling home prices are pushing more "wealthy" families (those with big homes, two car

- payments and children in private schools) into filing for Chapter 11 bankruptcy, according to the National Bankruptcy Research Center. Chapter 11 bankruptcy by wealthy families increased 73% in the second quarter compared to the same quarter of 2008.
- Defaults on credit cards rose to a record high in August.

We have had a few “less bad” months, primarily due to government stimulus. The “Cash for Clunkers” program boosted car sales for a couple of months. That program is over and car sales are anemic again.

The \$8,000 tax credit for first-time home buyers helped home sales a tiny bit temporarily. That program will be over in November.

So why has the stock market rallied so sharply the past six months? There are a couple of reasons, neither of which are good reasons to believe that stocks are a fundamentally good investment today. First, March 9th, in retrospect, appears to have been a “the world is coming to an end” panic bottom. At that time, there was no way to know it was the bottom. Just two weeks earlier, you could have invested in the stock market, thinking it was at the bottom. It had declined 48% from its peak....but over the next two weeks, it declined another 11%.

When stocks are falling 11% every two weeks (or even every two months), investors don't mind being in money market funds, even if the interest rate is close to zero. However, investors in general have short memories and short investment time horizons. After a few months of earning close to zero, investors tend

to get restless and want back in the water. With money market fund yields continuing to hover near zero in March, funds began flowing back into the stock market and continued throughout the summer.

At Boyer & Corporation Wealth Management, we continue to feel we are not in a “V” shaped recovery. Unemployment will soon exceed 10% and will take longer to decline than in past recessions. Employee layoffs appear to be more “structural” in nature rather than “cyclical”. That means even when business does begin to improve, we may not see any significant reduction in unemployment.

Earnings may appear to be improving for a quarter or two but only because companies have slashed costs, not because revenues are increasing. In addition, earnings may appear to be improving because they will be compared to the 3rd quarter of last year. If you recall, the 3rd quarter of 2008 almost brought financial Armageddon.

On my local bicycle route, there were 26 homes for sale at the end of September, the same as August. If you are reading my Investment Commentary for the first time, you should know that I began collecting this anecdotal evidence in the summer of 2007. There were 7 homes for sale when I first started counting. For over two years, the number of homes for sale has climbed into the mid-20's and does not yet appear to be on the mend.

We continue to see many longer-term economic problems globally. Low interest rates appear to be causing investors to mis-price risk (again). We remain cautious.

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