

Current Observations

FINANCIAL & INVESTMENT MANAGEMENT GROUP, LTD. • FEE-ONLY WEALTH MANAGEMENT

Managing Through Times Like These



by Paul Sutherland

I love times like these. Give me a market where things are rough and investors are panic selling, and I only see opportunity. Maybe I feel so comfortable because my formative years were during troubled times like these – like an emergency room doctor who prefers working the night shift and facing gunshot and knife wounds rather than working the day shift and dealing with coughs and runny noses.

Tricky Dickie, Vietnam, WIN buttons (Whip Inflation Now), Mexican currency crisis, hyperinflation, rising interest rates, high unemployment, a stock market malaise all coupled with rising and collapsing energy and home prices were hallmarks of 1973 to 1983.

We know 1983 marked the beginning of a great bull market in stocks and bonds that some naïvely still think is intact today.

Why do I enjoy markets like these? Simply because they offer low-risk investment opportunities. I don't like to lose money and hate it when our portfolios are down, but I realize that sometimes that's the way it is. No honest person gets to have great low-risk returns without some downside volatility. But nobody minds upside volatility. Find me a long-term successful business person or professional investor, and they will talk about 2008 and 1987. Business people will tell you about when they had to borrow against their mother's house to make payroll, or the year they had sales tank and the bank wouldn't extend a loan. They will all say that those are normal ups and downs of our economic world and that they profited from those periods.

Linda Brzezinski, who was my first employee in 1979, had the foresight to save copies of

all our newsletters over the years, even the ones typed on the old IBM electric typewriter. In the fall of 1987, the markets seemed jittery, so that October I sent a note to clients that included these lines:

The U.S. government has an opportunity in the next few weeks to take some steps that will be positive for the U.S. financial markets. The Gramm-Rudman-Hollings Act Amendment (GRH), the signing of the Arms Limitations Treaty with the Soviet Union, and with Congress' new appropriations bill (hopefully passed in the next few weeks) could create a perceived environment of great opportunity. The G-5 meeting of September 26 could help lower our U.S. trade deficit. All this could move the world psychology to look on U.S. assets favorably.

October 7, 1987

A few weeks later the market crashed (the Dow Jones was down nearly 23% in one day). The newsletter that we sent out afterward contained these very important lines that are still true today:

I think I have learned more about investment markets in the past two weeks than I have in 14 years. The worldwide crash in stock markets, the almost instant paranoia among the press and the freak-out behavior of James Baker, our Secretary of the Treasury, should scare anybody who has their eyes open.

More than ever before the recent uneasiness in the financial markets has catalyzed my belief in always having a diversified portfolio of carefully selected and managed assets. I thank God that we do not use speculative options, futures, leverages, and margin or programmed trading techniques to beat the markets. Many individuals and companies were decimated by such strategies. They were lulled into these strategies by a strong market, lots of hype and because everyone was doing it.

continued on page 2

MANAGING THROUGH ... continued from page 1

This market volatility has created opportunity for the disciplined, patient investor. Some stocks are down over 50%. Savvy investors are now nibbling away at these bargains, and many companies that are cash-rich are buying back their own shares. Will they profit in a few weeks? A few months? A few years? History shows us they will profit.

October 30, 1987

And then in December 1987, we sent out the following letter (excerpted below – also listed below are some leading stock market average declines):

Dow Jones Industrial Averages - @ 36.1% decrease
 Dow Jones Utility Averages - @ 29.3% decrease
 S&P 500 Stock Average - @ 33.2% decrease
 O.T.C. Composite - @ 29.3% decrease

The U.S. has had eight recessions since the end of World War II, and the stock market has declined in every one of them usually before the recession even started. Following every one of those eight recessions, the stock market has climbed to a new historic high. Naturally, we must be aware of the fact that the stock market could very well fall further, but if history repeats itself, it will surge to a new high well above the highs of a few months ago.

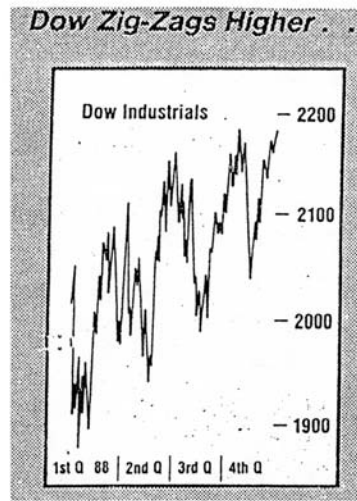
December 10, 1987

One year later I quoted *Barron's* magazine, which said, "What made 1988 truly great was that it was not 1930!" I think next year, *Barron's* will be able to dust off that line and say, "What made 2009 truly great was that it was not 1930!" Linda pasted a chart showing the volatility of the market in 1988. (see graph, right)

Then, naturally, we had a few years of relative calm until the Iraq crisis exploded, and we led off our August 1990 newsletter with the table on page 3.

And a few months later we sent out a letter titled, "Gloom ... But Not DOOM," stating:

Psychology is what ultimately drives financial markets up and down, and I find it amazing how



The DJIA in 1988

quickly people's attitudes about the economy can change. I remember begging clients to buy stocks and long-term bonds back in 1982 and telling them to sell gold when it was over \$800 an ounce. It's funny how when the markets are at their highs, everybody wants to buy and when things are low, everybody sells.

The gloom that pervades our markets today is amazing to me – people are panicking out of assets that they bought as "good investments" (nobody buys an investment because it's bad), expecting big profits, income or whatever. Then if the security goes down, it's a "bad investment," even if nothing has changed in regards to the investment. In our accounts that we are able to buy individual stocks in, we have bought some securities that are off from their highs, by over 80% in some cases.

November 2, 1990

Today's market reminds me so much of those wonderful years. We made money and navigated the terrain through the junk bonds, impotent portfolio insurance, indexing manias, silly government policies and even more silly political responses to economic and global events. Did we have losing months and years? Yes we did! Were our clients able to stay retired? Yes! Did our client portfolios grow as we saw the gloom as opportunities to buy and the boom as opportunities to sell, and the change as just plain opportunity? Yes! Today is no different ... significant, low-risk opportunities are available.

continued on page 3

MANAGING THROUGH ... continued from page 2

Country	World Stock Markets Before Iraq Crisis	August 1990	% change
U.S.	353.4	307	-13.1
Japan	20863.5	23727	-23.1
Germany	2355.9	1875	-20.4
France	439.2	363.7	-17.2
U.K.	1898.7	1604	-15.5
Canada	3541.9	3359	-5.2
Australia	1577.9	1493	-5.4
Hong Kong	3485.8	2871	-17.6
Singapore	2565.5	1128	-27.9
Korea	673.2	603.6	-10.3
Taiwan	5402.6	3333	-38.3
Average			-17.7

August 24, 1990

Imagine buying GE, Gannet, New York Times or AT&T at prices less than one-half of their former highs with cash dividend yields of over 5%. Well, that is reality today. Imagine being able to buy diversified global energy companies like BP, Royal Dutch Shell or ENI that are selling at around 40% of their former highs and that sport cash dividend yields of 5% to 7%. Yes, that is reality today.

We obviously were early, and I am not happy that the portfolios are down. We started buying energy companies at prices about 20% higher than they sport today. No one can get the timing perfect – but we bought at good prices, and unlike others who are panicking into CDs, we are and have been locking in long-term income from cash dividends and growth for our portfolios. And these are designed to thrive regardless of the future, be it inflation, depression, recession or a boom.

Life will go on, economics will rule, people will engage in economic activities, long-term investments are selling at great prices ... what's not to like? Oh yes, we have had some loser investments – Fannie Mae and Freddie Mac – to name two. That's why we diversify. Sometimes we get it wrong. Thankfully, however, we don't speculate with aggressive margins, options, futures, ETFs or indexing strategies. We concentrate on buying good investments at good prices. Thankfully, we are patient and, more important, our clients are patient. **F**

'Get Me Out' or 'Get Me In' – An Experience of Emotions



by Jeff Lokken
Wisconsin

I've worked in the financial industry 25 years, and each day provides an incredibly interesting learning experience. My cumulative knowledge and experience serve as a reference for the financial advice I currently give my clients and are especially valuable during challenging times for the stock market.

Recently, most of the major stock markets of the world have lost over 20% in value. Bear markets like this tend to shake the confidence of investors and inject the powerful emotion of fear into decision-making.

I remember one such experience on Monday, October 19, 1987, or "Black Monday." The Dow Jones Industrial Average dropped 508 points that day, losing nearly 23% – the largest one-day percentage drop in market history. Many things were different in 1987 than today. In particular, we did not have "instant" access to news flow via the Internet, and prices of stocks were mostly unknown throughout the day. All we had were radio and television news reports, so it was virtually impossible to react quickly to this news flow. At about 9:30 p.m. that evening, I received a call at home from a client. He was obviously stressed by the day's events and really didn't want to chat; he simply repeated several times, "Get me out." Although I understood his concerns, I was faced with two problems. First, the markets were closed, and second he didn't own any stocks. His only two investments were a money market fund and an investment-grade bond fund. At his insistence, we redeemed his funds the next day. Interestingly, he earned a profit because bonds actually went up as investors moved to a "flight to safety." We sent him a check and he felt much better. Subsequently, the stock market entered one of the most significant and longest bull markets in history. The NASDAQ rose from 330 at the end of 1987 and reached a peak of over 5000 in 2000.

In 1999, the NASDAQ Composite returned over 80%. Stock investors were euphoric and daily conversations were filled with excitement citing the amazing returns available to investors via the stock market and the latest "hot" technology stocks. Many new investors entered the bull market demanding to "Get me in." I recall a conversation with a retired client early in 2000. As a risk-reduction technique I had sold several of his appreciated stocks and purchased some bonds with an annual coupon rate of 8%. Upon discovery of this portfolio change he asked me, "Why would you buy an investment at 8% when you can make 80% in the market?" Within that year the NASDAQ peaked at 5132 but by year's end fell over 50% as the speculative Internet bubble burst. As I write this article, in September of 2008, the NASDAQ sits at 2096, down 60% over the past eight years. This makes those 8% bonds look pretty good. (see NASDAQ graph on page 5).

These two experiences illustrate the perilous power of fear and greed when making stock purchases or stock sale decisions. Research suggests that the stock market is mostly efficient in pricing stocks, referred to as the Efficient Market Hypothesis. However, at infrequent times of extreme market lows or highs, maximum pessimism (fear) or maximum optimism (greed) are prominent and causes stocks to become inefficiently priced. The study of behavioral finance, which explains how investors' emotions affect stock prices, have consistently shown that individual investors underperform market index averages. Unfortunately, individual investors are motivated too much by fear and greed and tend to buy high and sell low. Sadly, surrendering to these powerful emotions destroys their long-term investment performance.

In the near future, I will be able to characterize the current stock market experience

continued on page 5

'GET ME OUT' ... continued from page 4



© Copyright 2008 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All rights reserved. See NDR disclaimer at www.ndr.com/copyright.html. For data vendor disclaimers, refer to www.ndr.com/vendorinfo/.

and determine when we reached the point of maximum pessimism and low stock prices. This point will be the best time to buy stocks. Market bottoms are impossible to predict, but there are several tactics a wise investor should always implement:

- Keep an emergency fund to cover at least six months of living expenses in safe assets like certificates of deposit or money market funds.

- Aggressively pay down debt to reduce debt pressure, which may cloud decision-making.

- Expand your time horizon to long-term performance of at least three to five years.

- Invest a portion of your assets to generate income that will allow you to receive cash flow or continually reinvest in the down market.

continued on page 6

'GET ME OUT' ... continued from page 5

- Diversify assets across many companies, industries, countries and sizes (which we do for you at FIM Group).
- Focus less on the daily news flow and more on critical valuation metrics of stocks such as price-to-earning ratios, price-to-book value or other fundamental valuation techniques to make buy and sell decisions.
- Follow the smart money. These are investors and companies that will take advantage of market fear by giving one dollar to a scared investor to receive an asset worth significantly more.

Investors like Warren Buffet and companies that repurchase their own stock provide rational leadership.

Bear markets are emotionally painful in the short term, but historically they provide investors the opportunity to make big returns ... but only if investors do not succumb to fear. Here's to the next bull market. I trust we won't get too greedy. **F**

Making Money During Bear Markets



by Barry Hyman
Hawaii

Bear markets don't feel good, especially to those who don't have faith in economics, cycles and people. The lack of such confidence makes it hard to stay the course. A natural temptation after watching the market or the value of one's portfolio decline is to think about "getting out," moving to cash or hitting the "panic sell" button. Everyone knows you are supposed to "buy low and sell high," yet most people invariably do the opposite. Letting emotions drive investment decisions causes people to "sell low" more often than not. Trust and confidence are essential to avoid falling prey to emotions.

The majority of the public invests in assets when doing so is in vogue. Somehow it feels right to many people to invest after astute investors have already made the easy money and then get out while or after prices have "corrected." Invariably, when the dust settles we hear and read that some investors made a fortune by buying foreclosures during a real estate bust or buying

struggling companies or industries at a fraction of their value during a recession or bear market.

For most of us it is very difficult to fight the emotions (fear during a decline, greed during a run-up) and instead have conviction in sound thinking. For others it is second nature to understand the fear and exploit the opportunities created by others' emotions. Why is it easy for some investors to see the logic of buying when others are gripped with fear? I believe it is a matter of faith. For some, like the portfolio managers at FIM Group, that faith comes from a combination of experience and understanding along with knowledge of many previous cycles.

Have They Lost It?

"I think they've lost it," one client said about us recently. In reading the online newsletters of several investment management icons, it is the same thing many highly regarded managers are being accused of these days. The current environment is reminiscent of prior difficult market environments. During market cycles of the past two decades, FIM Group has been fortunate not to have suffered near the magnitude of the declines that many managers suffered, partly because we are smaller, more nimble and more

continued on page 7

MAKING MONEY ... continued from page 6

flexible. But, to the casual observer, we in fact look like we've "lost our minds," "missed the boat" or are "not paying attention" to what is going on.

Questions such as, "You're buying preferred stocks in banks and financial companies? Don't you guys read the papers or watch the news?" are quite common during periods like this, just as the questions of why we were buying beaten down "old economy" companies during the tech bubble or unwanted Asian stocks during the Asian Economic Crisis were common questions then. We are value and opportunistic managers. The best bargains are created when everyone is panic selling. It just appears foolish at the time and thus takes courage to buy them! Let's look at an analogous situation from the late 1980s.

The Savings and Loan Crisis

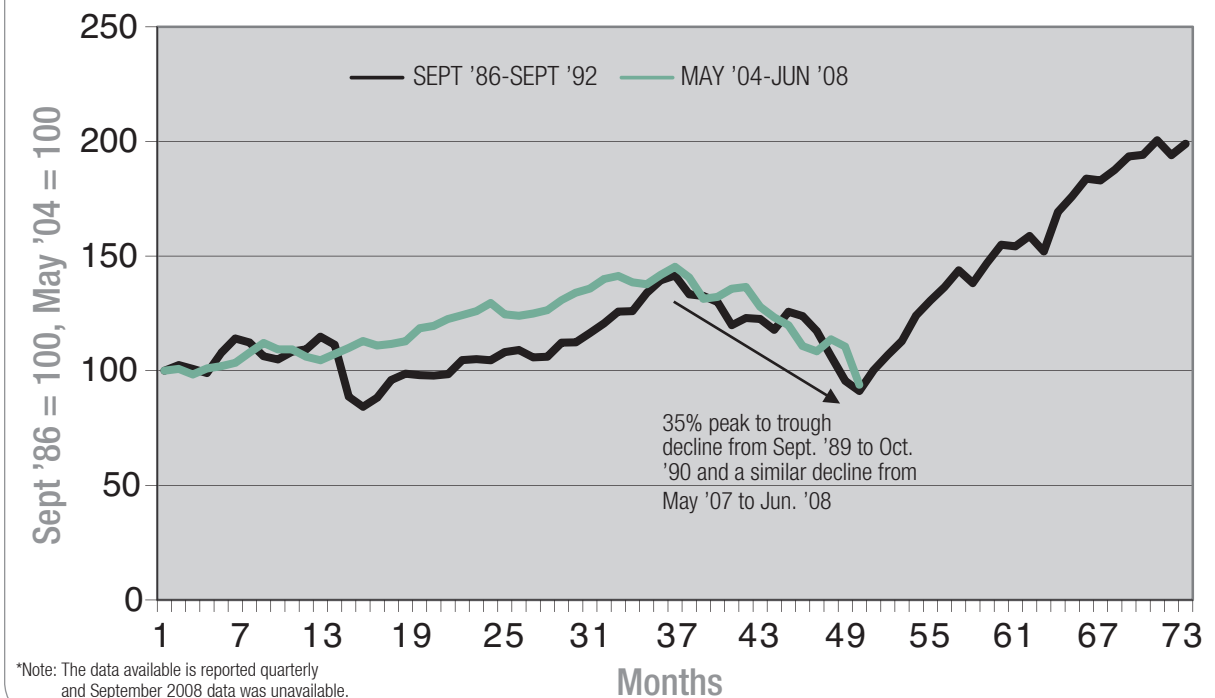
The S&L crisis was pretty much concurrent with the junk bond crisis; just as the current banking and credit crises are concurrent. In the

S&L crisis, the FDIC identified about 1,500 "problem banks" with serious deficiencies that threatened their continued viability (by contrast, the FDIC has identified only 90 such banks this time around, out of approximately 8,500 total banks in U.S.).

During the S&L crisis, investors panicked and sold off bank stocks, and in doing so created a great opportunity for long-term investors. Granted, something like 1,000 banks were shut down or taken over, but there was no way the government and the regulators were going to allow the financial system to collapse. Investors who seized the opportunity and had the courage to invest in a diversified portfolio of financial stocks reaped significant returns.

The figure below shows that from their peak in September 1989 (the black line at month 36), bank stock investments, as measured by the Morningstar Financial Category, dropped approximately 35% during the S&L crisis to their trough levels in October 1990. Investors who

Morningstar Financial Category Performance



continued on page 8

MAKING MONEY... continued from page 7

held onto their financials did just fine in the years ahead as sentiment recovered. Those savvy enough to average down their cost by buying more financials as fear dominated the market did even better (even if they didn't perfectly "time" the bottom).

The green line overlays the same Morningstar Financial Category leading into the current financial crisis. As of June 2008, this category is also down approximately 35% from its May 2007 peak as investors have once again

panicked. Expecting an exact repeat of the recovery made during the S&L crisis is probably not warranted. That said, the current environment of financial sector fear, combined with distressed valuation levels, does have our team optimistic that contrarian action today will benefit our portfolios over the long-term.

One of my favorite adages of value investing is, "You make the most money from bear markets – it just doesn't feel like it at the time." We are confident this is such a time. **F**

FIM News

Would you like to receive market updates and commentary via e-mail? Sign up at www.fimg.net to receive timely client updates and information.

Quote

"Be fearful when others are greedy. Be greedy when others are fearful."
– Warren Buffet

The Quiz

Since 1960, the average bear market has taken stocks down about 31% before they hit bottom, according to Ned Davis Research in Venice, Fla. Was the decline of 1973-1974 above or below this average?

- A. Above
- B. Below

Answer online at fimg.net to be eligible for a monthly prize.

Disclosure

Performance data quoted represents past performance. Past performance does not guarantee future results. All performance assumes reinvestment of dividends and capital gains. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. Performance data current to the most recent month-end may be obtained by calling 231.929.4500.

Founded in 1984, Financial & Investment Management Group provides global investment management solutions to individuals, corporations and advisers. Our dedicated and talented team of 43 professionals works from offices in Traverse City, MI, Onalaska, WI and Maui, HI. FIM Group actively manages more than \$650 million in client assets.

PUBLISHER – Financial & Investment Management Group, Ltd. (Hereinafter referred to as FIM Group). *Current Observations* is published 12 times per year, 111 Cass St., Traverse City, MI 49684; Telephone: 231.929.4500; Fax: 231.995.7999; E-mail: info@fimg.net; Web page: www.fimg.net. This and all editions of *Current Observations* is reviewed by the FIM Group Investment Policy Committee. All information presented herein has been compiled from sources believed to be reliable. However, no representation or guarantee is made as to the accuracy or completeness of information obtained from third parties. Readers are further advised that successful investing is more art than science and, therefore, no strategy, chart, graph, theory, philosophy, method, system or formula discussed in this newsletter can guarantee favorable results. FIM Group, its officers, directors, employees and members of their families (hereinafter referred to as "associated persons") may have established positions in securities that are recommended for purchase by FIM Group in this publication. FIM Group believes in following its own advice and encourages its associated persons to invest in accordance with the advice provided to its clients and/or subscribers. FIM Group client account transactions are given priority over those of its associated persons. Unless otherwise stated, all opinions in this newsletter are those of the individual FIM Group Representative preparing the article and are expressed with the understanding that: (1) the opinions are not based upon the individual needs or investment objectives of any individual reader or group of readers; (2) readers will seek independent investment advice from their adviser before making any investment decision; and (3) any favorable comment or recommendation made in this or future issues is not a representation or guarantee that following the recommendation will result in a profit or reduced loss. All rights reserved. Permission to reprint any material herein is granted provided full credit (including address) is given to FIM Group. In addition to publishing this newsletter, FIM Group provides investment counsel, portfolio management and financial planning services to its clients. Subscriptions to *Current Observations* are provided without cost to FIM Group's clients.

As per SEC Regulations, this is to inform all interested parties that Financial & Investment Management Group, Ltd.'s FORM ADV PART II is available upon request by writing FIM Group at: 111 Cass St., Traverse City, MI 49684.