

Market Update

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Where's Waldo?

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Where will the next mortgage loan casualty show up? Where in the world is Waldo? Bill Gross, the renowned bond guru of Pacific Investment Management Company (PIMCO) in California wrote a piece "Where's Waldo?" on August 20, 2007. In that piece, Gross likened the defaulting sub-prime paper and bad home loans in the US mortgage markets to Waldo. While market analysts attempt to estimate how many Waldo's might actually show their faces over the next few years, no one really knows where they are hidden.

The challenge of finding Waldo is several. First, financial engineers on Wall Street have created a maze of financial structures utilizing cheap money (low interest rates) without fear of any sting that could occur if unqualified borrowers ran into problems (as adjustable mortgage loans reset). Second, regulators have been absent from the game by over-rating quality (or lack thereof) of the bonds and being lax on the institutions initiating the loans. And, if some financial institutions (insurance companies) are not required to show bonds at market value (carried instead at amortized cost) on their financial statements, who knows where's Waldo or how big he is. Further the media (newspapers, TV, and internet) is manufacturing headlines which create a situation much like pouring gasoline on a fire. Default exposure may hibernate for many months before the magnitude is revealed. Thus, markets stand by with apprehension, wondering where's Waldo?

August was a traumatic month following on the heels of a difficult July. The Federal Reserve and other foreign monetary authorities are responding to create some stability to increased market volatility and a paralyzed lending market. They are injecting cash into the banking systems, and the Fed is lowering the Discount Rate (loan rate banks pay to borrow money from the Fed). These actions brought some relief by the month-end.

Clients may be surprised to learn that their portfolios and the major indices actually posted gains by the end of August. Large-cap stocks, as measured by the S&P500, gained 1.5% during the month. Growth style stocks outpaced value across the market-size spectrum. Foreign stocks trailed US domestic in August (not a common occurrence over the past few years). Higher quality bonds performed well as investors sought a safe haven from volatility in the stock market. Low quality bonds and some non-government mortgage paper was difficult to trade due to worries about Waldo.

Below are the style performance highlights for August and year-to-date:

	August	YTD
Large growth	1.9%	8.1%
Small growth	1.5%	8.2%
S&P 500	1.5%	4.8%
Large value	1.1%	-4.7%
Mid growth	1.0%	11.8%
Small value	0.2%	0.4%
Mid value	-0.3%	4.8%
Foreign	-1.3%	9.9%

The 3rd quarter (through August) is a negative performance experience for stocks in general, and lower quality bonds.

Aside from "Where's Waldo", investors are now fretting about the durability of the US economy. Will it slide into a recession? Research sources we review do not forecast that event. Risks have increased. But, there is resilience in the US economy given the strength of world economies and the very high probability the Fed will lower interest rates in September. Yes the economy is slowing as is inflation; a recession seems unlikely. Thus stocks offer an attractive buying opportunity, but near-term caution is warranted as the market trading activity does not show accumulation just yet.

We continue to be long-term investors of client portfolios. We are concerned about Waldo contagions. Our client portfolios are broadly diversified with different no-load mutual funds owning historically attractive performance experiences. We have reduced exposure to risky funds and believe portfolios should weather the current "rainy day" in good fashion. We expect portfolios will do well as the markets rebound. In the interim, we continue to encourage clients to maintain focus of their long-term investment goals and resist the temptation to emotionally pull the trigger to exit the market and thereby injure their opportunity for long term success.

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