

No Boom and No Crisis Last Forever

By Cathy Pareto, MBA, CFP® and Karla Arguello, MBA
October 2008

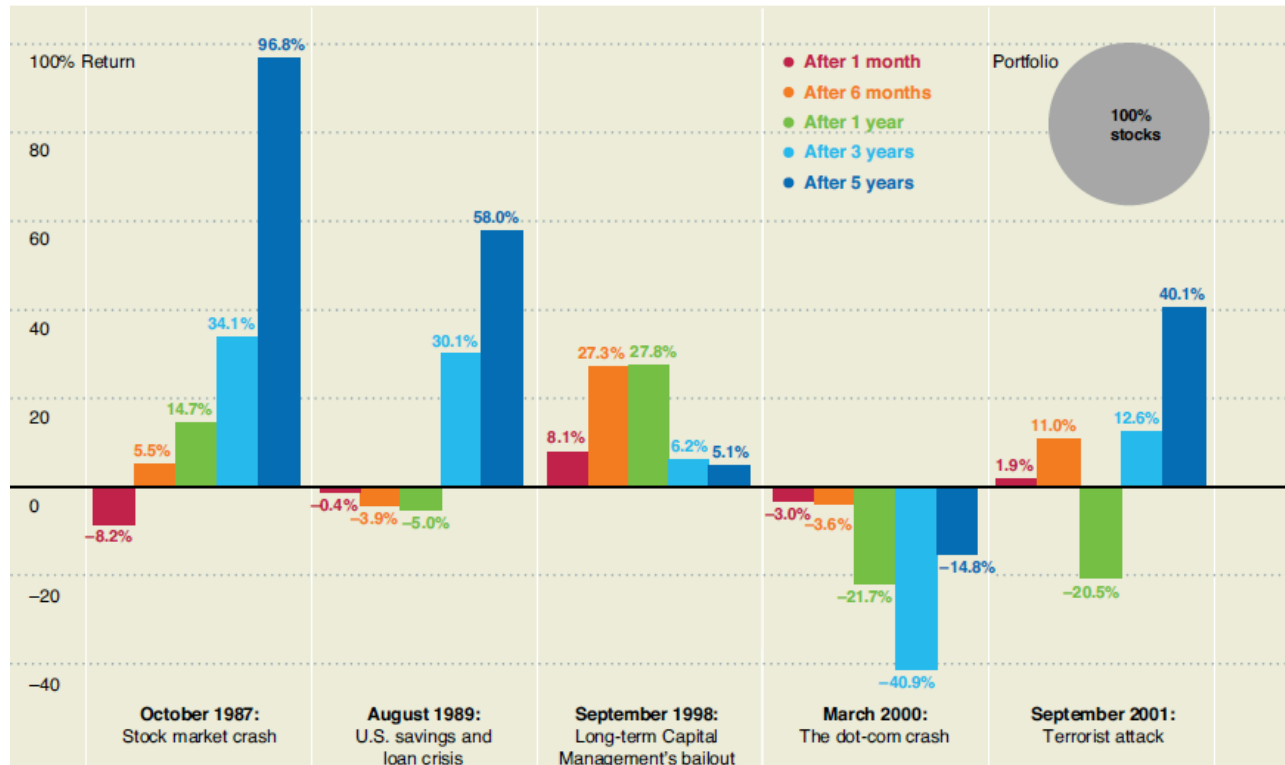
If history is any indication, we can deduce that no boom and no crisis last forever. It is no doubt difficult as an investor to realize this, especially now as we see the stock market declining right before our very eyes. This year will go down in history as one of the worst ever, and it's a jagged pill to swallow if you are an investor (in particular an investor approaching or in retirement). It's even more difficult to endure this rough period, as we are constantly bombarded by messages of fear and doom in the media. But, for just a moment, let us step out of this terrible situation to reflect on our reality and our history. After all, we are long term investors and must remain focused on our long term goals (as hard as that may be in these tumultuous times).

Let us begin this discussion with a brief review of some prior periods of financial distress, and/or crisis, specifically as they relate to market performance and time.

During financial crises, stock prices obviously suffer. This fact is quite evident in all the periods that are depicted below. However, we can also clearly document that markets do recover over time. **Lesson number one: No crisis lasts forever.**

U.S. Market Recovery After Financial Crises

Cumulative return of all-stock portfolio after various events



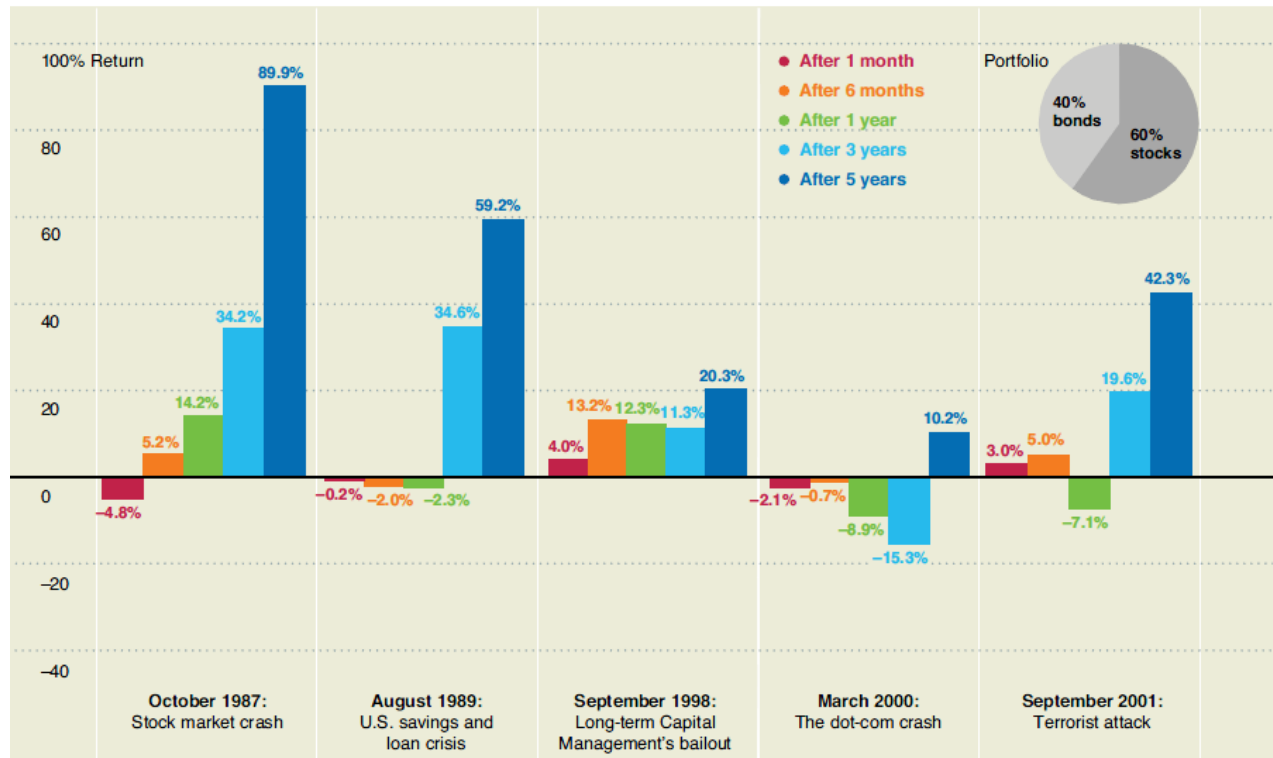
Source: Morningstar

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U.S. Market Recovery After Financial Crises

Cumulative return of balanced portfolio after various events



Source: Morningstar

These images illustrate the **cumulative** returns of an all-stock portfolio and a balanced (60% equities and 40% bonds) portfolio after five historical U.S. financial crises. In the short term, uncertainty from such external shocks can create sudden drops in value. For example, each portfolio posted negative returns one month after the October 1987 stock market crash. Over a longer period of time, however, returns were much more attractive, and investors who stayed the course reaped considerable rewards.

Make no mistake about it; emotions can be detrimental to a portfolio's value. Fear and uncertainty might lead investors to sell their investments during tough times, putting downward pressure on stock prices. But, by selling during downward price pressures, investors might realize short-term losses, even though the safe haven of cash seems quite alluring at the moment. Their losses are compounded as investors wait and hesitate to get back into the market, possibly missing some or all of the potential recovery. The lesson here is that patience can pay dividends, although that is incredibly hard to see right now.

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About the Data

In the above example, stocks are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. Bonds are represented by the 20-year U.S. government bond. The calculations assume monthly data and reinvestment of all income, but does not account for taxes or transaction costs. For the U.S. savings and loan crisis, August 1998 was chosen because that was the month the Financial Institutions Reform, Recovery and Enforcement Act of 1989 was signed into law. For Long-term Capital Management, September 1998 was chosen because that was the month the hedge fund was bailed out by various financial institutions. *Source: Morningstar.*

For those of you thinking “yes, but this is different”, remember that all of the depicted financial crises were different. And at that time the media and other convincing sources were saying that it was the end of the world.

The Importance of Diversification

Investing in the market is not and should never be regarded as risk free. The reason you can achieve great returns in the short term or in the long term is because there is risk associated with investing. Any investment that is considered safe will not yield you the returns needed to overcome inflation. Here's where the importance of diversification comes in. Because we know and understand that there is risk in the market we must do our due diligence in selecting our investments to ensure appropriate asset diversification in our portfolios. But even as you select investments that are negatively correlated to one another (meaning that they behave differently under market conditions) you can never do away with risk. Nothing can guarantee that losses will be avoided during declining markets. It is the extent or depth of those losses that can be minimized with sound portfolio construction.

Current Events

Now that we have reviewed past financial crises and we have regained our long term focus, it's now time to talk about *how we got here?* Let's start with the banks.

Banks

It used to be that banks took in deposits, cashed checks, and loaned money out to people who were in very good shape to repay those loans. Because the banks owned the loans they had to take greater measures to limit the number of potential losses from loan defaults. That was then...

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A few years back, banks or their brokers began to write out the loans, but instead of the bank keeping or servicing the loans, many of these were sold off to securities dealers and investment banks as mortgage backed securities (the process known as securitizing). The firms who bought these securities then received a payment based on the value of the mortgages. For the banks selling these assets, it helped them pool risk and generate capital, and for the firms buying these assets, it provided a source of cash flow with what was thought to be a very safe underlying commodity: real estate. Everyone was in on this to make money and risk measurements were thrown out the window for a quick profit. People (namely institutions) buying these types of securities did not realize what they were truly acquiring. After all, everyone thought the housing boom would last forever. **Lesson number two:** *No boom lasts forever.*

Wall Street

As the housing boom came to a halt, properties lost value, and the holders of fancy loans began to see their payments rise (think balloon payments, adjusting mortgages, etc.) and they could no longer meet their obligations. Case in point, (true story) how was it possible for an individual earning \$30,000 a year able to purchase a \$350,000 property with no down payment?! It was simply unsustainable, and the culmination of corporate greed, lack of oversight, consumer ignorance and moral corruption came to a halt. This is how we began to see the cracks in the system. Any company owning these mortgage backed securities began hearing the rumblings through their balance sheets. In June 2008 more than 4 million U.S. homeowners with a mortgage, a record 9%, were either behind on their payments or in foreclosure. This is what crushed Fannie Mae and Freddie Mac. The assets that were supposed to be backing their investments were worth less and less every day. Worse yet, these firms had to pay interest on that debt, but had no cash flow to do meet their obligations. Lehman Brothers, for example, had \$5.4B of debt obligations but only had \$2.3B in income before its collapse.

The Domino Effect

When you owe more than you can pay, you file for bankruptcy. In normal circumstances, that is where it would have ended. Unfortunately, this was just the beginning of the Domino Effect. Lehman Brothers owed money to other investment banks that were already in the same dire situation. And this is how regional, national banks, and Merrill Lynch began to tumble. But let's not forget the fact that these banks held insurance to cover such losses, insurance that was purchased from AIG. As the dominos began to fall, AIG got caught in the crossfire. To create some sense of correlation, it might as well have been the only hurricane insurer that was present in Florida during hurricane Andrew in 1992! If everyone you are insuring suffers losses at the same time you will go under, that's just how it works.

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Politics

Could all of this have happened at a worse time? Absolutely not. Not only do we have huge cracks in our financial system and it's outdated oversight, but far too many self serving politicians (pretending to know what is going on) are using this as a golden opportunity to satisfy disgruntled constituents just so they can ensure themselves a Congressional seat next year. Where were they when this fiasco was being conceived? Don't be fooled. The failure to pass the first version of the \$700 billion dollar bailout was nothing more than politics. Was the bill perfect? Who's to say, but lack of action is far worse than less than optimal action (that's our opinion). The markets lost what amounted to \$1.4 trillion dollars on 9/29/08 and it may continue to lose value. So, was the \$700 billion dollar price tag hefty? You bet. The question is, is the alternative better—that is loss of confidence and panic?

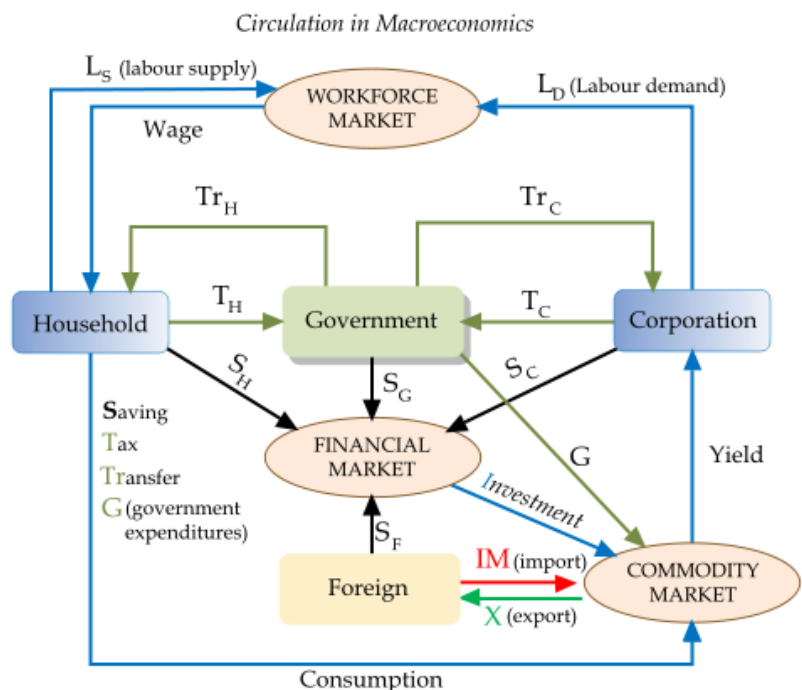
We can argue how right or how wrong this bill is until the new millennium, but the reality is that something needs to be done. Yes, some people who shouldn't benefit from the bill will benefit at our expense (the taxpayer), and that's very aggravating. But if we think as a long term investor we simply can't afford for people to lose faith in our financial markets, as the rest of the global financial systems watch in dismay and also get pummeled in the process. The foundation of a capitalist society (and believe us, we are capitalists at heart) is a well **capitalized** financial system. But, we need cash to flow so we can keep our system running smoothly.

Let's face it, we live in an interconnected world, as depicted this Macroeconomics graph.

Without healthy Corporations there is no employment, without employment there are no taxes, no savings, and no consumption. And without the financial markets we simply have no market.

What Will Happen Next?

Unlike what many "financial Armageddon" and doomsayers suggest, we truly believe that we will get through this. But, clearly, this



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will take time. Americans are too innovative as a population to simply wither away and die amidst troublesome times. We have survived worse situations before, we can survive now. Is it going to be fun, of course not! Will we be tempted to cave into our fears and buckle down under pressure? It's likely. But, we are a strong nation that is capable of overcoming incompetent leadership (and that is a bipartisan statement here) and reckless greed.

Our systems clearly need reform and are outdated to say the least, and our next president (whoever that may be) will certainly have his hands full trying to deal with this economic abyss. But, we will prevail, we will climb out, and your sound personal finance decisions today will no doubt impact your financial security tomorrow.



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