

Lighthouse Beacon

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Economic, Market Problems Should be Transient

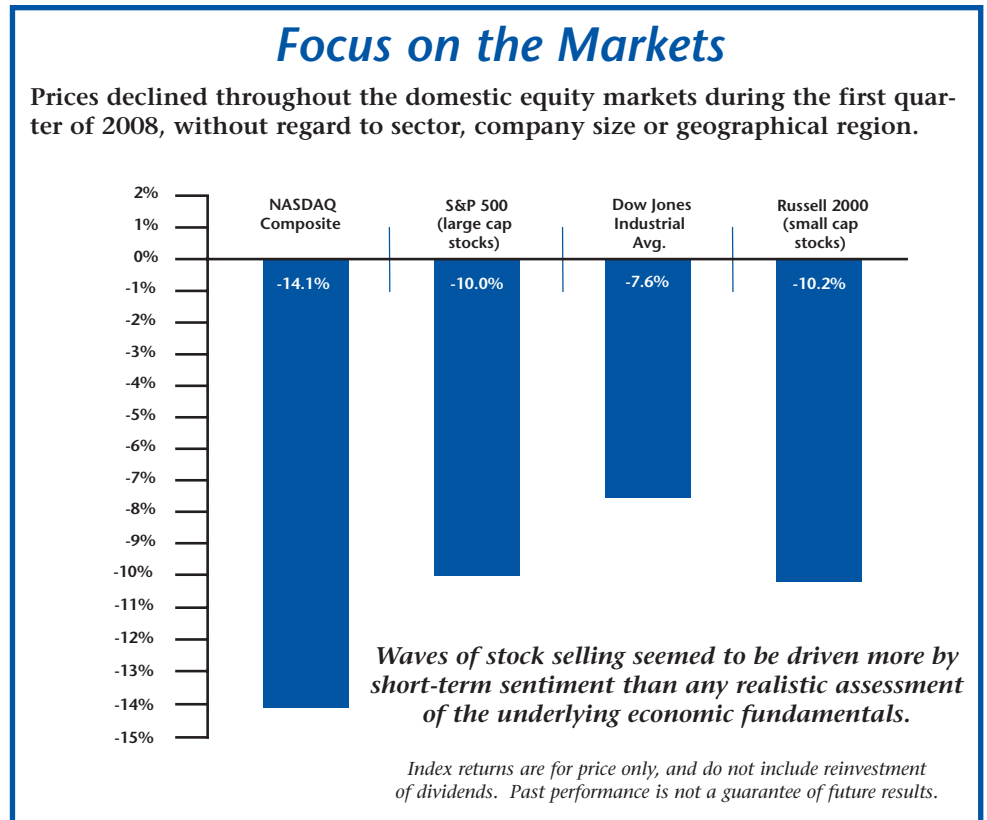
The nation's equity markets certainly got off to a difficult start in 2008. Stock prices fell during the first quarter, victims of the toxic combination of a dramatic deterioration in the nation's housing market, the seizing up of the credit markets and the rapid surge in energy prices. The declines were felt across the equity markets during the three months, without regard to industry, company size or geographical region. Waves of volatility also swept through the fixed income markets as bond investors sought to avoid credit risk by investing in only the high-quality securities.

Many investors clearly were frightened by the increasing talk of recession. It was not unusual to see the Dow Jones Industrials Average drop by hundreds of points in a single day, only to rise the next day. It was no wonder that confidence in the economy and in the markets was shaken, especially with regular media reports warning of every sort of economic cataclysm.

Is there anything that can be done to fix the problems? YES! Is all lost? No!

Don't pay attention to the doomsayers. In reality, quite a bit already has been done to reinvigorate the economy, buttress the markets and eventually restore confidence.

This is a time when experience in the markets matters. Those of us who have been in this business for more than 30 years have been through these cycles many times before. In fact, as difficult as the present problems may appear, we have witnessed many earlier cyclical downturns that have been even worse. Eventually, those problems passed and we were able to navigate out of seemingly perilous waters. It is critical to employ a disciplined investment process to



enhance capital over time, even more so during difficult times.

Most recently, many investors have made decisions based on short-term fears and market volatility rather than on any solid analysis of the situation at hand. They have forgotten the most important of lessons: focus on your long-term goals and the economic fundamentals, not on the near-term variables.

Time and again, history has shown the folly of trying to time investments by identifying favorable entry and exit points in the market. At the point at which most "market timers" have decided to sell, the market usually has already declined signif-

icantly. At the point at which they are comfortable enough to buy, the market often has already moved up sharply. The undisciplined, short-term oriented investor rarely buys low or sells high.

It is important to remember that results from long-term investing frequently are the result of the aggregation of a series of short-term market bursts. When you are in and out of the market in a vain attempt to identify the best "time," you are likely to lose the benefits of the combination of many of these short-term bursts over time.

These lessons are widely recognized and supposedly well understood. Yet,

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they frequently are forgotten during periods of pervasive negativism created when the media successfully has whipped everyone into a frenzy. And that's exactly what we saw during the first three months of 2008.

A long shadow was cast over the market by a "wall of worry" built on several building blocks, including: declining housing prices; subprime mortgage problems; vanishing demand for derivatives of mortgage-backed securities; rising prices of oil and other commodities; the weak dollar; the collapse of Bear Stearns; the fear of wider bank failures; nasty political quarrels that appeared to dominate the Presidential primaries; and the fifth anniversary of the Iraq War.

Well, we've been through volatile and uncertain times before and we will be in them again. They are part of the ebb and flow of economic and market cycles. We will get through this period and confidence will again return. We live in a country blessed with an economic vitality that has always come up with innovative solutions to seemingly unsolvable problems.

The Federal Reserve Board clearly has been doing its job to ensure the integrity of our financial infrastructure, pouring liquidity into the system and encouraging lending by the banks. The Fed has lowered interest rates, opened its lending facilities to investment banks as well as commercial banks, and positioned itself as the lender of last resort in times of distress. These actions, over time, should once again encourage more lending at affordable rates for housing and business loans and re-energize the overall economy. Congress, meanwhile, has provided further economic stimulus in the form of tax rebates which will reach consumers shortly.

One problem is that we all love simplistic labels: recession or expansion; bull market or bear market. Don't forget, a recession is defined technically as two consecutive quarters of negative change in gross domestic product (GDP). If history is a guide (and it should be), the economy very often already has started to recover by the time that statistics have confirmed that we had been in recession. Similarly, by standard definition, a bull or bear market occurs when the market either has declined or risen by 20% or

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Q: How did problems with subprime mortgages spread to become a threat to the major financial markets?

A: Many people had understood for some time that there were potential problems with at least some subprime mortgages. However, these potential problems did not receive much attention because the subprime mortgages were just a small part of the nation's mortgage business.

Less well known, however, was the extent to which brokers and investment bankers had been packaging risky subprime mortgages together with other mortgages and then selling the resulting securities to investors. These investors tended to be large institutions or hedge funds that typically borrowed, or used leverage, in hopes of increasing their gains from their investments. Unfortunately, the use of leverage also increased the risk further. These securities continued to be sold and resold until cracks started appearing in the foundations of the U.S. housing and mortgage markets.

Questions started being asked: What were the values of these securities if the values of the underlying houses were declining? What were the values of these securities if the homeowners could not meet their obligations or if the amounts of the mortgage loans exceeded the values of the housing? How could mortgage-backed securities be "marked to market" (valued appropriately) if it

was getting harder for anyone to receive a bid on them?

Mortgage-backed securities became illiquid –or difficult to sell. The investment bank Bear Stearns, which was heavily exposed to mortgages, found it could not sell its securities and it could not meet its obligations to repay the loans it had taken to buy the securities. All of a sudden, questions arose about the financial markets in general and highly complex, mortgage-related instruments that brokers, investment bankers, hedge funds and other financial institutions had been trading. These instruments, with names such as structured investment vehicles and collateralized debt obligations, were being traded back and forth each day based on the expectation that another investor would be willing to buy them on another day. All of a sudden, that expectation changed as no one knew how much value there was in a security or how much risk was attached.

At this writing, Congress and the Treasury Department were discussing reforms. These changes would, at a minimum, make the operations of the increasingly sophisticated financial markets more transparent and visible to the public and to regulators such as the Federal Reserve. While few people want to see heavy regulation that could suppress financial innovation and make the United States less competitive in world markets, most agree that everyone needs to be able to see with more clarity how the markets are working and what risks lie below the surface.

more. However, by the time you figured out that you either are in a bull or bear market, it usually is too late to do anything about it.

Ignore the labels. Don't be influenced by irrational fears or the effects of rampant speculation. The Federal Reserve and the federal government can do more if needed, and they are likely to take even more

aggressive action if necessary. So, try not to pay attention to the negativism and the media talk that nothing can be done.

Short-term problems always seem worse when we are in the middle of them. The disciplined, seasoned investor, however, remains focused on the long term and the underlying economic fundamentals.

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