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LESSONS LEARNED

With today's employment numbers, up to 5.7% unemployed, I think we can accept that we are indeed in a mild recession. We've been there since fourth quarter 2007, when Gross Domestic Product (in other words, the economy) actually declined. Since then, it's been anemic but positive. I am pretty confident that in hindsight they will revise their 2008 statistics downwards.

It feels brutal. Banks are failing one after the other. The giant government-backed mortgage lenders Fannie Mae and Freddy Mac are getting a giant pork-filled bail-out. Foreclosures have soared. Local real estate is down as much as 45% from the high, depending upon the property. Gasoline is above \$4 a gallon. The financial markets are very volatile. It feels terrible. Doom is in the air.

The statistics don't support such a profound level of fear as we are experiencing. What the numbers tell us is that we are experiencing a recession similar to 1991 or 2000.

Of course this time is different. This time it's about housing, mortgages, and gasoline. But the numbers are NOT saying that at this point we are entering The Great Depression #2.

It is true that everybody in charge has made mistakes. But history implies that we are likely to muddle through.

Gasoline will come down in an absolute sense. It will decline for one of two reasons, or both. The high price of fuel has driven us into a recession. So long as that economic slowdown endures, demand will decline. Therefore, the price will decline as well. The second reason oil will decline is that we will innovate. Yesterday I read about kits to make cars into hybrids retroactively. If the oil price stays high, we will curb consumption through efficiency. We will use less petroleum. The price will decline, relative to our incomes.

The July 13th government bail-out, the Paulson-Bernanke rescue plan, feels ugly to me. It protects shareholders at the expense of the taxpayer, it is laden with special interest pork, and it does little to keep our financial system from making the same mistake again. But something like this is necessary. Wall Street, mortgage brokers, and an unregulated financial system have cast us into a pit, and only a giant injection of capital like this will get us out. So the rescue is ugly, wrong-headed, but necessary. It will work. The July 28th edition of **Business Week**, with the apt cover, "*How Wall Street Ate The Economy...And What Happens Now*", points out on page 32 that this rescue is likely to cost about what this quarter's stimulus package cost us: about \$160 billion. Ouch. But something big is happening. The government has just told the world that a Fannie Mae mortgage is essentially a US Treasury. That should improve things a lot. Now would someone please stop them from issuing more high-risk mortgages?

Bottom line: this is ugly. Any response will be imprecise and carried out in the face of uncertainty and misgivings. But reality supports the idea that we'll recover, possibly sooner than most people think.

Meanwhile, you pay me to learn and to change. Here's what I'm learning. Here are the lessons I'm absorbing from the first half of 2008.

- 1. As a nation, we don't know much about money.** After back-to-back tech and real estate bubbles, the evidence is clear that some of us don't know enough to manage our own lives. We spend too much individually and as a nation. We don't save enough. We often engage in money-burning adventures such as divorce and addiction. And we occasionally invest in dreadful investments like zero-down mortgages or overvalued stocks. If you've been burned by some of this, you are normal. But the lesson of 2008 is that if we are to succeed financially, we have to become abnormal, compared to the average citizen. Financial success means not doing what everyone else is doing. That's hard.
- 2. The geniuses aren't.** Watching all this, it is striking how helpless our financial experts in the private sector have been. Mostly they've been very efficient at hand-wringing, and that's about it. Yet they portray themselves as financial geniuses, laden with advanced college degrees, full of knowledge to help us. When the tech stock, real estate, and mortgage markets were booming, the financial corporations had no trouble portraying themselves as brilliant. Yet looking at history, we must conclude that these people are not our friends. So far in the 21st century they have been the facilitators for two giant financial busts. Yes, we were dumb enough to buy their garbage, but they created it. The lesson of 2008 is to seek independent advice. The big houses have too much self-interest.
- 3. The regulators don't.** As a nation we have created what is known as a "moral hazard". Our guarantee of organizations such as Fannie Mae, Freddy Mac, and banks has encouraged them to tolerate too much risk. We are now about to create billions of dollars of national debt to bail them out. Watching all this, we can reasonably expect that banks aren't effectively regulated by anything beyond their own prudence. History tells us over and over again that our government deregulates when times are good, thus setting us up for a disaster, and then reregulates when times are hard, thus restraining the recovery. The lesson for me is to distrust the powers of regulators, and keep money market funds very low risk.
- 4. Better a live donkey than a dead lion.** Two times in a decade we have watched as the media and society depicted risk-taking bazillionaires as the financial template upon which to model our own investment choices. Two times in a decade these mentors have led us to ruin. It turns out that the World War II generation was right, and the "nothing down" talk show brigade was wrong. It's about saving. It's about time. Getting rich quickly by taking enormous risks is, after all, risky. Who knew? The lesson for me is to stick with a long term agenda.
- 5. Real estate did go down after all.** The more an investment is beloved, the more the market is booming, the more risky it becomes. ANY investment which is so inflated that people are saying, "It will never go down" is at high risk of a decline. Sometimes a collapse doesn't happen. Usually it does. I sat in my office from 2005 to 2007 and listened to the same mantra on a daily basis: "Real Estate Never Goes Down." The lesson for me is added self-confidence that if everyone loves it, it's probably at risk, and I should reduce my clients' exposure.
- 6. It was bad...and then it got worse.** You can't hang a number on the Frankenstein investments which Wall Street created in the mortgage markets. The risks involved in these synthetic bets using options, commodities contracts, and mortgage parts are entirely theoretical...until something goes wrong. At the moment, a big part of the problem is that we don't know the numbers. We don't know what the losses from this downturn will be. When I thought I saw clear signs of a bottom, I bought a small position in bank stocks, which promptly went down. The

bottom, it turned out, was somewhere south of where it was supposed to be. We'll get through this and thrive, if only because I will buy more as we go along and dollar-cost-average our way out. In the meantime, it's not pleasant. The lesson for me is to accept that downturns may take longer to work out than expected, and thus I should continue to move gradually. In other words, don't bet on the bottom.

7. **Vanilla is a nice flavor.** Speaking of Frankenstein, have you noticed the monsters which the mortgage industry assembled for less informed home buyers in recent years? These unnatural mortgages have all transmogrified into unaffordable home-wreckers. I have witnessed the impossible: good, intelligent, employed, financially responsible clients losing their homes because of bad mortgage choices. At the time of purchase, these mortgages were touted by mortgage brokers as the optimal choices. We can all learn the following lesson: you are ready to buy a house or any other real estate when you can put at least 10% down, and get a standard 30 year fixed rate mortgage for the rest. If you can't qualify for a 30 year fixed rate mortgage, don't buy a home you are likely to lose. Avoid negative amortization mortgages, nothing-down deals, balloon payments, and other schemes. Keep your mortgage vanilla: a 30 year fixed rate.
8. **Greed and Fear.** If we have a clear enough memory, we can remember back a few years when you *had to buy* real estate or you were a self-declared idiot. If you weren't borrowing up to your eyeballs you weren't "using the equity in your home". Remember that line? Greed sells, and we were greedy. Now as a nation we are deeply in debt and scared witless. Now fear sells. Three years ago we had bestselling books about nothing-down real estate and "Flip This House". Now we have "How to Survive the Coming Hard Times." I recently read an article on MSN.com wherein the author says we should sell all our value funds. That's fear for you. Lesson: At times we all feel the pressures of greed and fear. But they are just thoughts, generated in part by

legions of people who are trying to sell you something. These emotions won't help you at all with your long term financial plan. Recognize them as merely feelings, and let go of them.

9. **Diversification works.** During the good times, it's easy to accidentally focus on investments that are doing very well. That means that when the bubble breaks, as it probably will, you may be damaged. So you want to make sure that your investments span the spectrum of low to high risk. This might mean that you get left behind when one market is booming. That's ok: you'll pass the high-flyers when the wax melts.
10. **Guessing doesn't help.** Of course right along with greed and fear, we've been hostage to our assumptions. Every day is different, but some central themes have remained consistent through history. One theme is that the longer your time horizon, the more accurately you can predict some financial markets. I have no idea...and neither do you, really...what the real estate and stock markets will do in the next year. But, based on the reality of history, I can guess with greater accuracy that in ten years both will have recovered somewhat from where they are now. Once again, we are reminded that guessing about what will happen next month is only randomly successful. A long term plan, involving time, discipline, and consistency, should see us through to prosperity.

For more information about the psychology of risk aversion and how the prospect of a loss leads us to very irrational decisions, I recommend reading "**Sway: The Irresistible Pull of Irrational Behavior**" by Ori Brafman and Rom Brafman. It's very relevant to what we are experiencing now.

Administrative note: If you have an IRA, it may be a good idea to review your designated beneficiaries, especially if you opened the IRA a long time ago. If you are unsure, please call Laurie at the office and she can check on how you have designated primary and contingent beneficiaries.