



ANDRESEN AND ASSOCIATES

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SEPTEMBER 1, 2008

STILL WATERS

8/28/2008	Value	YTD %
Dow Jones Industrial Avg	11715.00	-13.30%
Vanguard 500 Index	118.41	-11.53%
Vanguard Bond Index	10.04	+1.90%

Today's revision of 2nd quarter GDP numbers from a 1.9% annualized rate to a 3.3% rate illustrates how unclear the economic situation really is. It's hard to know what is genuinely going on. A growth rate of 3.3% is actually a nice moderate growth rate. But it doesn't feel like the economy is growing, and I consider this number suspect.

Compounding the uncertainty is the bias of evaluators. During the boom times, real estate appraisers and stock analysts were under a great deal of social pressure to deliver inflated results. They complied and participated in the over-valuation of real estate and individual stocks. After all, it is human nature to seek professional and personal approval. Now these same evaluators are under tremendous social pressure to undervalue assets, to render pessimistic assessments. How affected are they by this pressure? We won't know until later. Meanwhile, we can assume...human nature being what it is...that what we are reading is mostly negatively biased.

If you have been watching your account, you have probably noticed that some of the funds which were doing badly have improved, while some of the funds which were leading have now lost money dramatically. The result of all this turmoil is that many funds, regardless of investment style, have about the same performance trajectories and year-to-date performances.

(SEE GRAPH 1)

This has been a particularly harsh example of what is known as a sector rotation. I've been waiting for it, but I am nevertheless impressed by this rotation's speed and ferocity. As you can see in GRAPH 1, these funds are down from their year-to-date highs. It has been a turbulent and uncertain year. All in all, I think this rotation is a bullish indicator since it indicates people are starting to think rather than merely react.

The variation of performance among mutual funds can be explained by the strategic difference between value and growth mutual funds.

Value mutual funds are pools of money professionally managed by people who buy and sell stocks based on intrinsic value. In other words, they buy based on what the individual stock's value is now. "Deep value" mutual fund managers scour the markets like vultures looking for troubled stocks which have a break-up value, or even physical equity, which is greater than the current price.

A few of these funds are Longleaf Partners, Sequoia, and Mutual Shares. Other more mainstream managers, such as the managers of Sound Shore and Columbia Value and Restructuring, apply this logic but also look for unnoticed income streams which investors may be ignoring.

Undervalued stocks are available surprisingly often, and sometimes through surprising venues. Sometimes the value manager may buy the bonds of an over-leveraged company, and engineer a debt-for-equity swap. This relieves the company of its debt and often restores it to profitability. The now-retired Michael Price of Mutual Shares was famous for doing this. Sometimes a company falls out of favor due to style, as Apple did about a decade ago. And sometimes, as we are now witnessing in the financial sector, an entire industry is caught up by a tsunami of bad news, and good companies' stock prices are depressed along with bad companies' stocks.

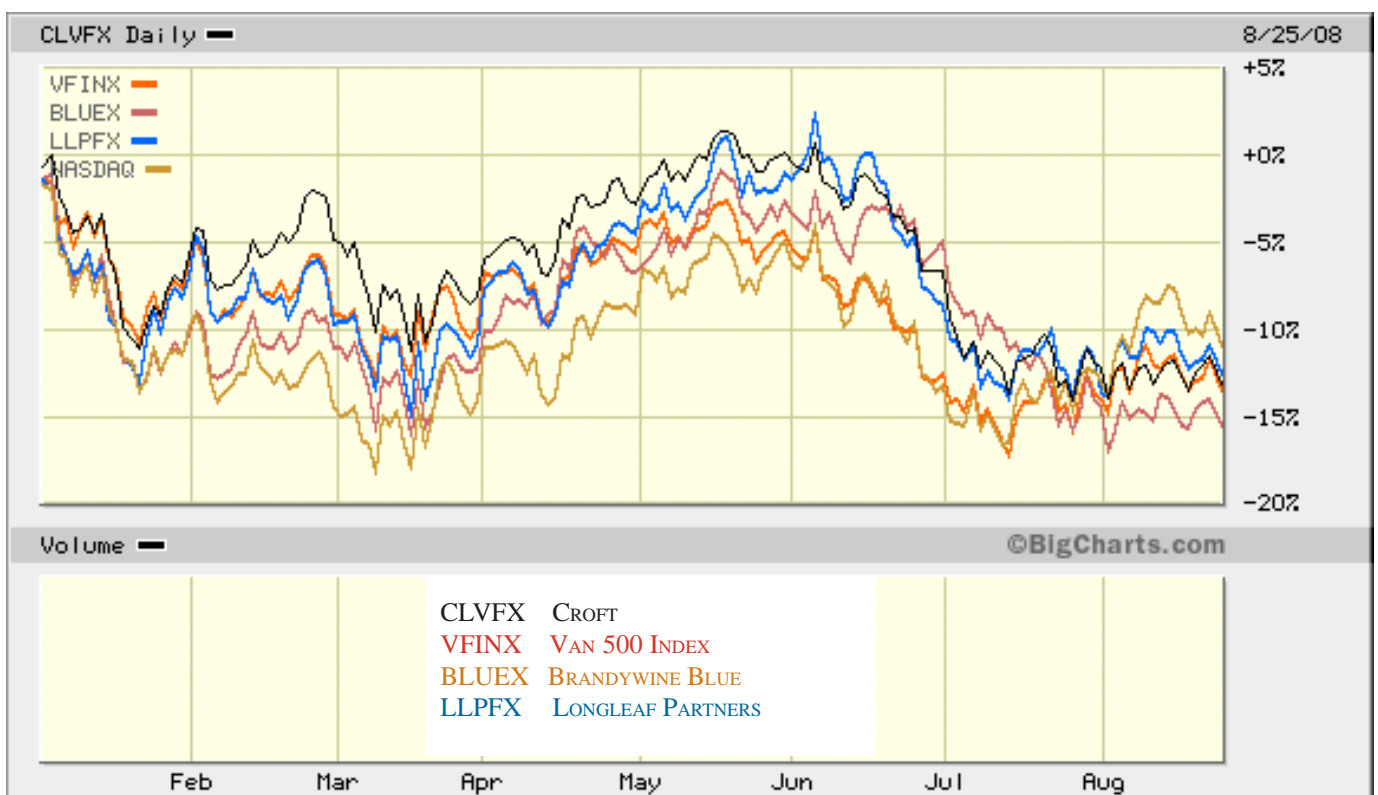
Bank stocks have plunged in value as the mortgage and real estate bubbles have collapsed. Many bank stocks are down over 50%. The exchange-traded fund I use to follow the global financial sector, IXG, is down over 25%.

Some of these stocks are deservedly damaged, because they have engaged in either unwise or unethical lending. But some of these bank stocks are actually very good corporations that have been caught up in the crisis of negativity which now envelopes the entire industry. And, to make things even more confusing, the numbers keep changing. We don't really know what will happen to real estate, and we don't know how many bad mortgages are out there. As I mentioned earlier, at this point there is a reasonable chance that what we are reading is biased negatively.

Value fund managers are compulsive bargain hunters. They can't resist a bank stock with a clean spreadsheet when it falls 50% in value. They rush to it like carp after fish food. Often this works magnificently. But in 2008 the selected stocks continued to plunge. Value funds with a tradition of lower risk, such as Dodge and Cox Stock Fund, are down as much as 15% year-to-date.

In 3 to 5 years, I feel that these value fund managers are going to be redeemed by above-market performances. I agree with these managers that some financials are bargains. Some financials are garbage. The challenge is that nobody really knows the difference now.

GRAPH 1



Growth fund managers have taken a different course in 2008. Growth funds are pools of money managed by professionals who seek out growth of earnings. Any price is the right price if profits are soaring. As a result of this strategy, growth funds as a class tend to be a bit riskier, but they can also deliver soaring results when the conditions are right. Some of the best are Brandywine, Brandywine Blue, Quaker Strategic, and Croft.

At the beginning of 2008, the biggest growth of earnings was taking place in only two sectors: energy and commodities. So, of course, that is where growth managers invested. For the first half of the year, that worked relatively well, as oil headed towards \$140 a barrel. Many growth funds outperformed value funds during the first six months of 2008.

Then, inevitably, oil and commodities topped out. Demand declined due to higher prices and an economic slowdown. Inventories began to grow. Prices, and thus earnings expectations began to decline. With plunging earnings expectations went the growth fund managers, fleeing like a herd of geese before a sheep dog.

My proxy for energy stocks, the Vanguard Energy Fund, has fallen over 20% from its high in mid-May.

Those declining stock prices suddenly washed away the relatively superior performance of growth funds. In June, I watched several growth funds lose 12% in 20 days. Ouch.

It was worse if you switched from value to growth in mid-year, since you were selling value funds low and buying growth funds high. Your losses were even greater if you were in a private hedge fund. Some of those have simply gone under.

Meanwhile, the economy continues to signal that we are experiencing a downturn but not a catastrophe. The August 25, 2008 real estate report from the National Association of Realtors indicated lower prices and higher sales volumes. In other words, we are getting through the traditional process of a market cycle. At some point, probably in 2009 or 2010, we will begin the next upturn and the global economy will improve.

My thought is that this is all very uncertain, and investors are trading too much. Historically, our most successful course of action has been to let these proven managers

do their work free of our second-guessing. That's my basic plan for now. My plan is to simply assemble a selection of proven growth and value funds, as well as funds which invest in other sectors of the financial markets, such as international, balanced, and bond funds. Then my intention is to let the managers do their magic, and wait this out.

In their book *"The Psychology of Investing"*, authors Lifson and Geist discuss a controversial Morningstar study of real investor behavior. During the years 1980 to 1992, the Fidelity Magellan Fund, captained by Peter Lynch, delivered an annual performance of 29%. Yet the average investor lost money in the same mutual fund. This happened because the psychological pain of loss is so intense for most of us that we must get out of the investment. So investors during this profitable period tended to buy Magellan high...and sell at any decline. By responding to their fears, they transmogrified a very profitable opportunity into an ego-punishing ordeal.

Let's not do that. It's time to stop, take a breath, consult reality, and grow some patience. This downturn will inevitably end, and our portfolios will rise again. We have mutual fund managers working for us with literally centuries of combined experience negotiating markets like those we face today. Most other investors may decide to embrace the tempests of popular angst. I am opting for still waters. ●

**We will be hosting an investment seminar
for clients and guests**

"The Ten Lessons of 2008"

Thursday, September 11, 2008

6:00 - 8:00 pm

158 W. Gabilan St., Salinas

**A light dinner will be served.
Please call if you plan to attend:
Laurie or Pete (831) 758-1575**