ANDRESEN AND ASSOCIATES

FEE ONLY INVESTMENT ADVISOR

P.O. Box 1434 Salinas, CA 93902
(831) 758-1575 or 1-800-345-9644
www.andresenassoc.com

-- *Planning the Recovery* --

10/28/2008	**Value**	**YTD %**
Dow Jones Industrial Avg	8175.77	-38.4%
Vanguard 500 Index	78.25	-41.2%
Vanguard Bond Index	9.66	-1.1%

Thoughts on the Current Markets

We are inside the panic of 2008. This is clearly the worst financial panic I have experienced in my professional life. Even safe investments are down precipitously.

As you know, I have been predicting a decline in real estate, mortgages, and petroleum for a long time. My expectation was that by taking us out of mortgages, real estate, and energy, we would largely escape. My plan was to avoid the meltdown by avoiding the affected sectors, much as we were able to evade the meltdown in tech stocks in 2000.

In reality the panic's contagion has spread far beyond the confines of the original market sectors. It has spread into formerly safe investment venues where rampant selling has terribly wounded our formerly low risk mutual funds. I suppose there is some small comfort that we are not in mortgages, individual stocks, or hedge funds, many of which have simply evaporated.

I believe that we must acknowledge where we can improve so that we can change to make things better. With that in mind, I wish I had allowed my natural paranoia to float to the surface more in the past few years. The lesson is learned. Obviously, I chose to invest in traditionally reasonably safe investments, which declined with everything else. Also obviously, I chose investments which, unlike other choices, are still viable. Recovery is still possible. In fact recovery is probable. That's what this newsletter is about.

Recovery

We now face three basic investment choices:

1. Sell out of stock mutual funds and move to cash.
2. Sell out of stock mutual funds and move to income oriented balanced funds.
3. Ride this out to recovery.

In the past few months, global stock markets have crashed. They have crashed because terrified investors have chosen to sell their stocks at any price. The driving engine of this storm has been hysterical fear. That fear has been expressed as a distrust of every institution. As a result, investors have sold simply because others were selling. Then, as prices plummeted, others sold because prices were declining. As always, this financial collapse was defined by a nihilistic cycle of panic-based selling. This is not rational. It is essentially a stampede.

So should we get out? If we sell out of stocks now and go to safer investments, we will lock in a fearsome loss, and our portfolios will take a much longer time to recover.

The best reason to sell out now is if you honestly feel that we are going to experience a decade long depression. If that is the case, then you should be in cash, or CD's. Call me and we will do this.

The worst reason to sell out now is if you feel that the financial markets are going to continue to decline, and then recover. If you feel this is what is going to happen, and you want to go to cash, then what you are essentially saying is that you or I will be able to successfully time back into the stock markets. That rarely happens. We are probably facing a "two steps forward, one step back" sawtooth sort of market pattern. We won't really know that we're recovering until we are up 30% from where we are now, and we don't slide back. In other words, we won't see the recovery until it has already happened.

Thus, if we go to cash now, you are likely to lock in a loss and then give up 30% of the recovery waiting to get back in. As my father used to say on the ranch before the bronc launched me into the ozone, good luck with that.

I honestly don't know what will happen in the next few months. The data I have relied upon has been inadequate. Nevertheless, I am not cashing out in my own account. I am buying. I see what is happening out there and I think we will see a full recovery in five years, even if the markets go down a bit from here.

Selling out of pure stock funds and moving into balanced funds makes sense if you feel that we will have a "hockey stick" stock market: down, then flat for a decade. In that financial climate, dividends and cash flow are king. If stocks themselves don't grow much, then the income and dividends produced by our investments will constitute most of our total return. In this scenario, recovery will be a decade-long incremental process and pure stocks will lag income investments all the way up. If you are a conservative investor, I am already moving a little of your money in this direction, just in case. I will move more if a recovery fails to materialize.

I am buying a small amount of balanced and bond funds in my own account, but not much. Mostly I am buying pure stock mutual funds because I expect a recovery. But I won't hesitate to move us all to balanced and bond funds if the political solution to this mess is botched or the global economy is simply too damaged. This is my "Plan B".

"Plan A", as you have probably guessed, is to simply ride this debacle through to a recovery. It is terrifying. It is also something the financial markets have been through in past decades. However, it's new for us because I've always been able to dodge or outrun the bear before. In fact, as I am writing this, a client has just emailed to tell me that "The investments you bought for me suck." Yes they do. Everything sucks. Ouch!

I still expect a recovery. Here's why:

1. The Federal Reserve is pouring vast amounts of money into the system. It is just beginning to have an effect. This is different from the Great Depression when the money supply actually contracted. So we can reasonably expect that this isn't Great Depression the Sequel.

2. Currently the Price/Earnings Ratio is changing as earnings ratchet down. But at the moment, the P/E of the S&P 500 is about 10, which is signaling an unusual bargain.

3. The S&P 500 has a dividend yield of 3.5% while the 30-year Treasury bond is giving us a yield of about 4.1%. So to beat the 30-year Treasury bond in total return from current levels, the S&P 500 needs to give us a capital gain per year of .6% or more, in addition to its dividend. In other words, the S&P 500 will outperform the Treasury bond if it makes even the tiniest capital gains.

4. The Value Line Median Appreciation Potential, otherwise known as the VLMAP statistic, represents the median appreciation amount expected by Value Line analysts in the next three to four years. Value Line is a venerable stock analysis company. This statistic correctly predicted the bull markets of the 1980's and the 1990's. At an expected 135% appreciation, it is now more bullish than it has been in decades.

5. The stock market's long-term average annual return since the beginning of the 20th century has been calculated to be about 10%. This includes all the bear markets, all the challenging times, and the Great Depression. Given that statistic, let's consider the following scenario. Assume that our portfolios finish down 30% in 2008. Our $100,000 at the beginning of 2008 becomes $70,000 by December 31, 2008. Beginning in 2009, let's conservatively grow the account at 7% a year. Essentially, it takes five years to recover. Of course, we don't really know what will happen. But realistically, recovery within five years is entirely plausible. Sometimes it happens even faster. Sometimes it takes a little longer. However, it is hard to envision a situation in which cash outperforms the stock market for such a long period of time.

In my view, we got here from a "This Time Is Different" mentality in both government and society. Most of us thought that this time really was different, and that oil, real estate, and gold would never go down. Rising real estate markets would keep all mortgages safe. In fact the overvaluations in real estate, mortgages, gold, and petroleum DID follow history and collapse from their overvalued states.

Now, history —from the Tulip Bulb Mania of 17th Century Holland through the financial panics of the early 20th Century, the Great Depression, the stagflation of the 1970's, the Crash of 1987, and the tech bubble—is telling us that we will recover. Never in history has a panic like this taken place without an eventual recovery and restored prosperity. The only question is how long the recovery will take.