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Email Update

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## Please Read This Today

We have arrived at a rare, but not unprecedented, place in economic history. The actions we take now can and will have an irreversible impact on our financial futures.

In this update we will give you insights you are not getting and cannot get from the media. Our express goal will be to focus you on your future, both near term and long term, and to try to tone down the constant negative misinformation being reported and repeated by virtually everyone from the news media to politicians (including the former and current Presidents) to your friends and neighbors.

## How We Got Here

Today's economic problems can be blamed on all of us, from Wall Street to Main Street, to Capitol Hill, and all the way to the White House. Much of this is a story about unintended consequences.

The good intentions of our elected officials to want to share the "American Dream" of home ownership with as many Americans as possible paved the way to where we are today. By giving incentives to lenders to loan money to marginal buyers, they interfered with the system. The Federal Reserve's decision to fight our last recession by reducing interest rates to very low levels and the subsequent decision to keep them low for three years made housing much more affordable.

Soon, many of us realized we could afford a bigger house and we "upgraded". This led to rising home prices as demand for homes increased. Quickly, people recognized they could own more than one home since the "new reality" made it seem that home prices would rise indefinitely, possibly forever. Not long after, it became obvious that owning condos required less maintenance than owning multiple houses, and condos became the hot idea. Finally, as greed overtook common sense, this "new reality" led people to believe you could buy condos before they were even built, and flip them to an even greater fool for an easy profit.

Meanwhile, Wall Street (whose sole mission is to create products they can sell) wanted in on the real estate boom since the stock market was unpopular. They decided to "securitize" these mortgages being taken out by the new real estate tycoons, so they pooled together these mortgages and sold them to investors as "safe" investments. Since this took the mortgages off the balance sheets of the people who originated the loans, it took little time for the originators to realize they would incur little risk to make more loans, and of course, the more loans they made, the more money they'd make.

Meanwhile, in 2004, in response to a similar rule enacted in Europe, the SEC allowed five major brokerage firms to reduce their required net capital, thereby allowing them to leverage their balance sheets more than before. It was assumed they would "only" double their leverage, though at the time the SEC admitted they had no real way of monitoring these firms. Once again,

greed overcame good sense and they leveraged much more than expected, and their investment of choice for the leverage was all too often mortgage pools. Once the real estate market's proverbial greatest fool was found, and it began to inevitably cool, the leverage began to violently unwind. Those five brokerages were: Bear, Stearns, Lehman Brothers, Merrill Lynch, Morgan Stanley, and Goldman Sachs. The first three essentially have ceased to exist, and the last two have morphed into banks in order to survive.

This was shaping up to be very similar to the financial problems we faced in the 1990-1991 recession. Back then, we had a real estate bubble that had burst, and financial institutions were facing insolvency due to real estate loans that were defaulting. The government created the Resolution Trust Corporation (RTC) and subsequently thousands of banks and thrifts failed. However, that financial crisis didn't occur in a presidential election year, so there was no need for the President to warn us we were facing Armageddon. Consequently, the recession lasted a mere eight months and the stock market downturn was much less severe and much briefer than the current mess.

It's important to know that financial crises do not necessarily lead to economic crises. However, if left unchecked, or dealt with ineffectively, they will always lead to economic problems. Last fall, in order to convince us we needed the Troubled Asset Relief Program (TARP), President Bush and Treasury Secretary Paulson warned us that the country would face the next "Great Depression" if we didn't enact the TARP. Shortly thereafter, Senator Harry Reid and Congresswoman Nancy Pelosi echoed that message in order to gain political cover in case the TARP didn't work out. That was unfortunate, not just because it wasn't remotely true, but because it amounted to yelling "fire!" in a theater crowded with investors. Nearly immediately, as a nation, we panicked.

People sold their stocks, their mutual funds, their bonds, their alternative investments, and more. At its peak, the panic had people worried about CDs and bank accounts, and nearly caused an old fashioned run on the banks as people briefly decided that only cash was safe. As is typical in a panic, people postponed all major financial decisions, and many minor ones. Consequently, in September and October, consumer spending fell off a cliff. It's here where a financial crisis can begin to create an economic crisis. Marginal businesses immediately began to struggle, and a few filed for bankruptcy. Many others announced layoffs in order to prepare for a long economic slump.

So now that we have spread around the greed and responsibility, the question becomes what now?

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## Where We Are Now

As fascinating as it may be to ruminate over the details of how we got here, it's much more important to examine where we actually are now, so we can work towards understanding where we believe we are headed. As a start, you'll need to forget virtually all of what you've seen reported on entertainment TV (also known as news programs).

Panics are bad, but systemic economic problems are worse. Though both the current and previous Presidents told us we were facing an economic crisis worse than anything since the Great Depression, that simply isn't true. While significant, our economic problems are only now about as bad as the early 1990's. So far, we have experienced no where near the problems we faced in the early 1980's or early 1970's. But, rather than quibble with Presidents, it's probably more useful to discuss

what we are seeing now.

Panics cause people to temporarily stop most economic activity as they “hold their breath” and wait for better news. Eventually, we all have to exhale. Panics historically lead to “V-shaped” recoveries as people start to release their pent up demand. An early sign may have occurred last November.

It was to be expected that retail sales and consumer spending fell off a cliff as people panicked in the fall. Immediately prior to the official holiday shopping season, retail sales were off 20% year over year. Then came “Black Friday” and “Cyber Monday” right after Thanksgiving, and sales were actually higher than the previous year. The media launched into an attack on that data, explaining away the positive news as the result of rock bottom sales that had lured everyone into completing all of their holiday shopping in one weekend. Clearly, they didn’t understand male holiday shopping patterns!

The media’s current, constant stories are how no one is buying cars or houses, mostly because no one can get financing. We contend the current housing and car sales slumps are more evidence of a panic, and not as a result of actual economic conditions.

The current pace of car sales in this country is about 10 million cars sold. That’s about 28,000 every day – which is a pretty big number if no one can get financing! More importantly, though, is that 10 million cars sold is an unsustainably low demand. We will scrap more than 13 million vehicles this year. I don’t recall media reports of a car sales bubble. Car sales will have to rise about 30% to return to normal.

We do know there was a housing glut as builders did what builders do and continued to build new homes even as demand waned. But according to the National Association of Realtors, we have eleven months of house inventory for sale. They consider the market to be in equilibrium when we have six months of inventory. Home sales are expected to be in the area of five million this year. New home construction has virtually stopped – currently at about 500,000 annually. The normal replacement cycle for homes in this country would mean we will need to replace nearly two million homes this year. So, while we may not be at the very bottom of the real estate market, when we move back towards normal supply and demand, you can expect new home construction to nearly quadruple.

Ok, you may be thinking, enough economics talk, what about our investments? Where is the market headed?

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## Where We Believe We Are Headed

We know unequivocally that all markets bottom at points of peak pessimism. When the proverbial last person who could be convinced to sell their investments sells, the markets start to ignore bad news, mostly because there’s virtually no one left to sell. (Of course, the converse is true. About 3 years ago, more people owned condos on Miami Beach than at any time in history and prices were higher than ever. It was at that point of peak popularity that prices peaked. There was essentially no one left to buy.)

At the bottom of the stock market decline in 2002, more people sold their stock holdings in their retirement plans than ever before, until 2008. In 2008, twice as much money in retirement plans left the stock market and went to cash than ever before.

At the market bottom in 2002, there was so much money in money

market funds (as a result of people going to cash at exactly the wrong time, as they always do), that we knew a rally was in the offing. Today, there is more than twice as much money in money market accounts as in 2002. In fact, the amount of money in cash, short-term CDs, savings, checking, and money market accounts is nearly equal to the entire value of the US stock market. That is such unprecedented evidence of people's panic as to defy description.

For several years we have been warned that foreign countries who hold our treasury securities could suddenly sell them back to us, depressing their prices and therefore raising our interest rates. In fact, the opposite has occurred. Demand has been so strong that people – out of fear – have been willing to accept 50 year low yields on treasury securities. For the first time in 58 years, the yield of a 10 year treasury bond is less than the dividends on stocks. The bonds are structured so they cannot grow, stocks are nearly 50% off of their highs. (Please note that this does not legally guarantee anything, especially in the short run.) But, as much money as is currently sitting in cash and equivalents on the sidelines, there's much more parked in treasuries for "safety" that'll backfire as rates inevitably rise and people realize their "safe" treasuries are losing value.

The total rate of return of the stock market over the past decade is so low; it has only been this bad four other times in nearly 200 years. The average rate of return for the decade following those other four times was 14.5% per year, meaning stocks nearly quadrupled. (Again, regulators and lawyers want me to remind you that past performance is not a guarantee of future results.)

All of this section's information was intended to tell you that we are living in extraordinary times. Our political leaders and our pathetically ignorant media have combined to scare the dickens out of us. And they've been more effective than nearly any time in the past. Just like times in the past, the typical forecast is that this is worse than ever and we may never return to life as we knew it. That has always been wrong in the past, and we are confident it'll prove wrong once again.

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## What You Must (and Must Not) Do

Without overstating it, the financial future of you and your loved ones may well depend on your current actions. Please read this carefully.

In our last email to you, we described in detail how we allocate your investments so that the odds are in your favor that the money will be there for you when you need it. It is critical that we remember the plan that we put into place at a time like this.

For most of you, the money you have in the stock market is primarily in your "long-term" bucket. It's this bucket that is needed to provide you a growing income in retirement, whether now or in the future. Despite what you might hear on CNBC or local news, the rules of our economy and our markets haven't changed. The only asset class capable of providing a long-term return greater than taxes and inflation is stocks.

In recent weeks, some of you have begun to recognize this for the opportunity that it is, and have found ways to begin to add to your investments. Others, however, have not heeded our warnings to ignore the news media and have kept your eyes glued to the markets each day. Our current retest of the November market lows has prompted some calls about "what we should do now". Some of you may even feel frustrated by what appears to be a lack of "action" on our part.

When we created your plan, events like this were taken into account at the outset. We allocated your portfolio in a manner designed to give you the best odds of long-term financial success. We diversified the investments to strive for lower volatility and more consistent returns. (In the panic last fall, there were few places to hide as people sold everything.) We selected managers with consistent, long-term track records. At the individual fund level, these managers have been very busy reallocating their investment mix to most effectively participate in the coming recovery. Many had accumulated large cash positions that they have recently begun to deploy where they see opportunities. So the appearance of inactivity does not mean nothing is happening with your investments.

For those of you who have recently been tempted (whether by the media, or perhaps your family, friends, and neighbors) to join the panicked crowd by liquidating your investments, we need to explore that thought.


If current market levels are scary to you, and you are worried about losing more value of holdings, consider this:

- If you sold today, and the market suddenly declined by another 15%, would you be more likely or less likely to want to jump back in? (If you're honest, you'll admit you'd be much less likely. Please note, we are not predicting another 15% decline.)
- If you sold today, and the market suddenly appreciated by 15%, would you be more likely or less likely to jump back in? (Again, if you're honest, you'll admit that most of you would want to wait until it got back down at least to where it is now before you bought back in, except that once you start playing the timing game, it's hard to stop.)
- To time the market correctly, you have to be right at least twice. You have to know to get out before the market declines, and you have to know when to get back in before it recovers. No one in the history of the world (and no software program ever invented) has ever been able to do that more accurately than guessing. And we'd never guess about your long-term wealth.

We cannot know whether the market will temporarily decline more than it has already. We cannot know precisely when the rally will begin in earnest. No one does and we wish every one else would admit this too. We do know history tells us that much of the recovery takes place in the early stages of a rally. (If you review the discussion at the beginning of the last section, this is because we get to a point where there are few, if any sellers left. Therefore, a relatively small amount of buying tends to propel the market higher in the early stages of a recovery.)

Please remember these trends:

- The market tends to rally months before the economic news turns positive as the market acts as a forecaster.
- The news media is loathe to report positive news, since they know it's negative news that keeps us tuned in.
- Unemployment is a lagging indicator, and it will likely peak late this year, though the economy will likely show evidence of recovery by mid year (but we won't "know" that until months later, just like we didn't "know" it had started until months after it had.) This will not stop the media from reporting, as they always do, that rising unemployment proves the economy is getting worse, which won't be true.



Keep the faith, and know that we are here for you watching out for your family's financial future. One of our most important roles is to act as "big mistake insurance", so you don't act like your friends and neighbors, and so that your financial results aren't like theirs.

Feel free to share this with your family, friends, and neighbors. It may make your life easier if you know they're also getting good advice.