Market Update

Mounting Fears Shake Markets

Dear Valued Client,

The events that have occurred over the last several days in the financial markets have been the result of a culmination of the year-long credit crisis. There continues to be a great deal of uncertainty on the ramifications these unprecedented events will have on the U.S. financial system and the economy going forward. In the last week alone we have witnessed the collapse of Lehman Brothers, a 150 year old investment banking firm; the acquisition of Merrill Lynch by the Bank of America; and the Federal Reserve's $85 billion bailout of American International Group (AIG), one of the world's biggest insurers. A week earlier, top Fed officials helped coordinate the take over of mortgage titans Fannie Mae and Freddie Mac and was instrumental earlier in the year in facilitating the sale of Bear Stearns to J.P. Morgan.

We are witnessing a massive deleveraging that is taking place, the consequences of years of excess leverage that Wall Street had come to regard as normal under a historically low interest rate environment. This transition, which began in August 2007, is occurring more rapidly and violently than many had expected. The ferocity of the transition itself has exposed the market to a web of interconnected liabilities, often associated with complex derivative instruments and credit default swaps. The market turmoil is doing more than inflicting losses on investors. Signs of stress continue to proliferate in the credit markets as well. A spike in LIBOR (London Inter Bank Offering Rate), a benchmark reflecting the rates at which banks lend to one another, and a plunge in three-month Treasury bills have widened the so-called Treasury/EuroDollar (TED) spread, a measure of financial stress, to its widest levels since the stock-market crash in 1987 — an indication that banks have no interest in lending to each other. Borrowing costs for U.S. companies have skyrocketed and the debt markets have become nearly inaccessible to all but the most creditworthy borrowers. The obvious question all of this raises is the extent to which the bulk of the bad news, or at least the bulk of the poor performance of many risk assets, is behind us. Unfortunately, we believe the credit crisis is likely to linger further as this deleveraging process unravels and further volatility in the market is to be expected.

Historical Perspective

Considering the alarming headline news and the stock market's sharp decline, it is natural for investors to question their resolve and abandon their long term investment strategy. However, we believe it is important to understand the recent events as well as the cyclical nature of the markets before jumping to conclusions and abandoning long-term investment strategies.

First, volatility is a normal part of the financial markets. Sell-offs are common, normal and healthy. Secondly, the current crisis is unique, yet familiar. From a historical perspective, the U.S. financial market has been very resilient to global events. It was approximately eight years ago that the U.S. financial system was seriously tested with the collapse of the tech boom, the horrific events of 9/11 and the collapse of Enron, WorldCom and Global Crossing. Within this backdrop, from a market peak in March 2000 through October 2002 the market declined 49%. However, since hitting a low in October 2002, the market has since returned 83.2% through June 30, 2008.

Looking back even farther, the Russian Debt Crisis and the collapse of Long Term Capital Management in 1998 triggered a massive bailout by a consortium of leading U.S. financial institutions; the 1997 Asian Financial Crisis sent shock waves throughout the global markets; the 1994 Mexican Peso Crisis resulted in the peso losing half its value; the Savings & Loan (S&L) Crisis resulted in the failure of some 747 savings and loan associations at a price tag of approximately $160 billion dollars to the U.S. taxpayer, while 1987's Black Monday marked the biggest single-day drop in Wall Street's history. These were all very real and traumatic events that tested the resiliency of the U.S. financial system. Not surprisingly, in each crisis the markets sold off sharply. In fact, initially markets react negatively to the uncertainty surrounding the event, taking down not only those companies directly impacted by the event, but also companies with no linkage at all. It becomes a market event that is subject to sell-offs, more a function of emotion or forced selling, but unrelated to individual company fundamentals. Eventually, the markets rebound as investors refocus on fundamentals. It is the fundamentals that eventually drive investors back into the markets and drive share prices higher.

Investors are asking themselves "Is it different this time?" While the worries are the same and the uncertainty persists, the economy and the market are different than they were during either the Great Depression, or as recently as the bear market from 2000 to 2002. Structurally, our economy is more stable and prone to fewer and shallower recessions. Profits and balance sheets outside the financial sector remain healthy, inventories are at very low levels, interest rates remain low and inflationary fears have abated as commodity prices have retreated from their summer highs. Both the U.S. Treasury and the Federal Reserve are more engaged and have far more tools at their disposal than they did 80 or even 10 years ago, and are likely to influence the financial sector toward a business model with lower leverage and lower risk, with the likelihood of greater capital requirements and oversight. Once the deleveraging of those institutions unwinds and is complete we would expect liquidity to return to the markets, making available the necessary capital to allow healthy companies to expand and for investors to recognize this in rebounding markets. Unfortunately, the depth and breadth of the necessary deleveraging is greater than most understand, making the process longer and more painful. We are confident, however, that this will eventually unwind and the markets will recover, although the timing is unknown. Look for stability and recovery of housing prices to lead the way.

We know this is a difficult time for the markets and for our clients. Extreme market reactions can be very distracting for investors. Despite recessions, wars, 9/11 and political change; stocks, real estate and bonds all provided the potential for good long-term returns. We suggest investors continue to remain focused and disciplined on their long-term goals and maintain a diversified* investment portfolio. It is important to remember that asset allocation* is one of the most effective methods of optimizing performance and moderating risk. The term asset allocation simply means the apportioning of asset categories such as stock and fixed income investments and cash equivalents.

At USI Advisors, our research team will continue to diligently monitor the ramifications of these major changes in the financial sector and the market as a whole. We will continue to keep you informed on how these issues impact your investment funds and strategies.

Sincerely,

USI Advisors

*Diversification and asset allocation do not guarantee against a loss, nor do they guarantee that a diversified portfolio will outperform a non-diversified and/or non-asset allocated portfolio