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Will The Market Ever Recover?… *(continued from page 3)*

I have tracked the daily movement of the popular indices and there have been at least three times in the last seven months when it appeared we had reached the bottom and then the market dropped another 10 to 15%. When I have asked people in the last two months, "If we had been wise enough to have gone to cash last summer, would you be willing to go back in now?," their answer was almost always "no."

Going forward, I continue to believe that diversification is the only answer. People who have had money in cash, fixed investments, and/or government bonds, notes or bills have not had to sell their equities or corporate bonds and thus have not "realized" real losses, only paper losses. As painful as the paper losses have been, I believe we will recover those losses sooner than most people think.

As always we are available to discuss your personal situation, so please feel free to call anytime.

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BATES Briefings

Spring 2009

from George's Desk

WHO IS RESPONSIBLE FOR THE FINANCIAL CRISIS?

It is appalling to me that so far Congress has escaped **any** responsibility for the financial crisis our nation faces. I would contend that Congress is at the root of the problem. Its failure to learn and act from recent threats to our financial markets, its failure in its oversight responsibility of the Securities and Exchange Commission (SEC), and its continued public insistence that the banks failed to use the TARP money for the purposes intended – improving credit availability – while the Federal Reserve and Department of the Treasury (under the administration of both President Bush and President Obama), demanded the monies be used to reduce their leverage and increase their reserves. This is hypocritical at best.

Let me support my accusations with fact, not "political rhetoric." Most knowledgeable people would blame the crash of the stock market in 1929 on the excessive leverage that was allowed where investors could (and did) buy $1,000 worth of stock with $100 cash while borrowing $900 from the brokerage firm (otherwise referred to as margin accounts). Fortunately, the Congress in 1934 learned the lessons of the negative impact of excessive leverage and passed the Securities Exchange Act of 1934 giving the Federal Reserve broad powers to regulate the brokerage firms and banking institutions. Out of that legislation came rules limiting margin accounts to 90% assets and 10% credit. That has since been reduced to 50% assets and 50% credit. It has been reported in numerous places that the average leverage of the major financial institutions on Wall Street last year was 40 to 1.

In 1933, Congress passed several other important pieces of legislation, one of which was called the Glass-Steagall Act that created a "Chinese wall" which separated investment banking from commercial banking. That law served the country well until 1999 when former Senator Phil Gramm (Republican of Texas), with the encouragement of the then Secretary of Treasury, former Goldman Sachs executive, Robert Rubin, prodded the Congress to pass the Gramm-Leach-Bliley Act which negated the Glass-Steagall law. Thus, banks like Citibank were able to acquire insurance companies, investment brokerage companies and investment banking companies, resulting in the "too big to fail" dilemma we find ourselves in.

In the recent biography of Warren Buffett entitled *Snowball*, there is an entire chapter on his involvement as a major investor in Solomon Bros. in the late eighties and early nineties. To be brief, in 1990 and 1991 Solomon Bros. was one of the few firms approved to participate in the auction process of new issues from the U.S. Treasury. They violated Treasury Department rules and when discovered, the Secretary threatened to permanently ban Solomon Bros. from its privileged participation in any future auctions. Mr. Buffett informed Secretary Nicholas Brady that if Solomon were banned, they would be forced into bankruptcy due to the fact that they had only $4 billion in assets and $146 billion in liabilities. Understanding that Solomon's bankruptcy would seriously impact the U.S. financial markets, the Secretary relented.

In the same book, there is reference to the bankruptcy of Long-Term Capital Management in 1998 and the Federal Reserve Bank of New York having to step in and back the excessive leverage the hedge fund had employed so as not to seriously affect the world financial markets.

The U.S. Congress' response to these recent examples of how excessive leverage by a major financial institution could have huge disruptive effect on financial markets resulted in absolutely

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From George's Desk… *(continued from page 1)*

NO ACTION. In fact, efforts to legislate additional regulation and oversight of major financial institutions were defeated in the U.S. Senate led by Senator Chris Dodd of Connecticut and in the U.S. House of Representatives led by Representative Barney Frank of Massachusetts. Both of these men benefited personally by protecting Fannie Mae and Freddie Mac from additional oversight.

Regarding the SEC and their responsibility to regulate Wall Street brokerage and investment advisory firms, I have read in *Investment News* of only one executive at the SEC that has been forced by Congress to resign and that was because her department was responsible for the Bernard Madoff scandal. To my knowledge, Congress has not forced any other SEC executives to resign.

In addition, Mary Schapiro, the new chairperson of the SEC, testified before the Senate Finance Committee during her confirmation hearing that FINRA, of which she has been the recent CEO, had no responsibility for the Madoff scandal because his broker-dealer firm had no customers; however, as an owner of a broker-dealer that is a member of FINRA, I have recently received a letter stating that I will have to pay additional assessments to SIPC to fund some of the losses of customers of Madoff's broker-dealer. Interestingly, the SIPC was established to insure, within limits, losses experienced by customers of broker-dealers, not registered investment advisory firms, which Mr. Madoff testified was the type of company through which he bilked his investors out of billions.

I am not so naive as to think the leaders of financial firms on Wall Street that created these highly complex financial instruments and from which their firms made billions of profits, do not share some of the responsibility. That is why we have laws passed by Congress to regulate business activities in this country, so as to protect us. In addition, those laws and regulations are changed from time to time for public accountants, aviation, broadcasting, public utilities and numerous other industries and professions to further protect us.

I agree with President Obama that greater transparency is needed in Washington. I would suggest that the media in all formats could assist greatly in achieving that objective by publishing more of the kind of information I have included in this column.

DO YOU NEED AN ANNUITY?

Recently while reading a current issue of *Investment Advisor Magazine* I came across an article about the dramatic increase in the sale of immediate fixed annuities. My first reaction was an unconscious nodding of my head up and down. My second reaction was that this is contrary to what most people would do in a less emotionally driven marketplace.

Over the years I have found very little resistance to people choosing to take their pension in a lump sum versus a guaranteed monthly income. I believe rightly so. They want, and in most cases need, greater control of their financial future. The unknowable of how long one might live, how much the rate of inflation may change, and when, or if, any one individual may need to tap into some of the principal for a number of personal or family circumstances, makes it unwise to "lock-in" a large part of many people's largest single asset. Purchasing an immediate annuity is the same as locking in a portion of one's principal.

On the other hand, for people to take money out of ownership investments (e.g., the stock market, real estate) when prices are suddenly plummeting in order to buy a fixed guaranteed income when interest rates are at record lows seems equally unwise.

Let me stop to explain, what immediate fixed annuities are and how they work. First, they are an irrevocable contract between the investor(s) and an insurance company to pay a fixed amount of income for life or a specific length of time. Second, the amount of money it takes to "buy" that income is determined in the case of a specified length of time, almost entirely by current interest rates. In the case of an income for life, it is determined by both current interest rates and the life expectancy of the annuitant(s) (the income recipients).

As you will note, current interest rates are a major factor in both cases. The reason is that the insurance company invests that money in bonds and mortgages to provide the income. The amount of annuity income is based on the expected earnings and a systematic draw down on the principal over the expected pay out period. What that means in a simple statement is the lower the current interest rates are, the more money it takes to "buy" that guaranteed income.

So what does all this mean? That to take money out of something when its value is temporarily low to buy something that requires more money than usual because interest rates are low doesn't make much sense. So why are people buying more immediate fixed annuities when the stock market and real estate values are extremely low? Because they are scared and annuity salesmen are only too willing to make an easy sale that pays them very high commissions.

Can You Relate?

Two little boys, ages 8 and 10, were excessively mischievous. They were always getting into trouble and their parents knew all about it. If any mischief occurred in their town, the two boys were probably involved. The boys' mother heard that a preacher in town had been successful in disciplining children, so she asked if he would speak with her boys. The preacher agreed, but he asked to see them individually. So the mother sent the 8 year old first, in the morning, with the older boy to see the preacher in the afternoon. The preacher, a huge man with a booming voice, sat the younger boy down and asked him sternly, "Do you know where God is, son?" The boy's mouth dropped open, but he made no response, sitting there wide-eyed with his mouth hanging open.
So the preacher repeated the question in an even sterner tone, "Where is God?" Again, the boy made no attempt to answer. The preacher raised his voice even more and shook his finger in the boy's face and bellowed, "Where is God?" The boy screamed and bolted from the room, ran directly home and dove into his closet, slamming the door behind him. When his older brother found him in the closet, he asked, "what happened?" The younger brother, gasping for breath, replied, "We are in BIG trouble this time, GOD is missing, and they think we did it!"

THE 2009 STIMULUS PACKAGE

The stimulus package has been passed by Congress, signed by President Obama and is coming to our rescue as I write this note. Since we are all going to live with and pay for the stimulus, we thought you may be interested in knowing if there is anything in it that you may want to pursue. What follows is a brief overview of the package and its benefits (hopefully) to you.

Tax Cuts – About $380 billion of the stimulus program is tax cuts to individuals and programs to help individuals such as extended unemployment benefits. Many of you will receive or are now receiving these tax reductions. For practical purposes, these reductions will come in the form of credits, $800 per year for couples and $400 for individuals. This credit is refundable, so even if eligible individuals pay no federal tax, they will receive a refund.

Businesses – The ability to expense as much as $250,000 as part of the 2008 stimulus package under President Bush has been extended to 2009. Additionally the 50% bonus depreciation allowed under the 2008 stimulus plan has been extended for 2009.

Help After a Job Loss – The first $2,400 of unemployment benefit received each year is no longer subject to income tax. If after losing your job, you use COBRA for health coverage, the premium will be reduced to 35% of the total. The balance is paid by the former employer and reimbursed by the government.

Alternative Minimum Tax Relief – The AMT exemption amount is $70,950 for couples and $46,700 for individuals.

Energy Efficiency – Increased credits are available for installing solar panels or making certain other improvements to your home that will make it more energy efficient. The maximum credit has been increased to 30% with a cap of $1,500 combined over two years. There are specific limits for different types of improvements.

Electric Car – Purchasing an electric car could get you a $2,500 credit. This phases out after the manufacturer has sold 200,000 units.

Education – A credit of $2,000 on the first $2,000 of expense and 25% of the next $2,000 is available to help offset college expenses. The credit is for years 2009 and 2010, and is phased out for taxpayers with gross incomes starting at $80,000 for single filers and $160,000 for joint filers.

Buying a New Car – State, local and county taxes paid on the purchase of a new car can be deducted for the first $49,500 paid for a car, truck, motor home or motorcycle. This benefit phases out if gross income exceeds $250,000 for joint filers and $125,000 for single filers.

First Time Homebuyers – A first time homebuyer is defined as anyone who has not owned a home for at least three years. This credit is equal to 10% of the home purchase amount up to a maximum of $8,000 and is available to those with gross incomes of up to $75,000 for single filers and $150,000 for joint filers. You lose this credit if you sell your home within three years.

This has been a very general and brief review of the stimulus package. If you have any specific questions, please feel free to contact us.

WILL THE MARKET EVER RECOVER?

For those of you who were unable to attend our Client Appreciation Day I would like to summarize some of the information I shared with those who were there.

First, as I wrote about in my column in this issue, I believe much of the financial crisis we are facing could have been avoided or substantially lessened if Congress and the regulatory authorities, already established, had been doing their job. I also believe they have avoided much of the blame by pointing their finger at Wall Street. Further, I believe you and I must hold them accountable, by writing letters to our Senators and Congressman and withholding our support for those who fail to take responsibility and descend into partisan bickering.

Second, I have heard from a number of clients that this economy and the stock market may not recover for a long time. One of the graphs that I included in my handouts showed the length of previous bear markets over the last 80 years. Only the market crash of 1929-32 and the tech crash of 2000-02 lasted more than 22 months, and in every case except 1937 the markets recovered within two or three years of the low.

In addition, there have been some remarkable stock market recoveries when the economy and the mood in the country could not have been worse. 1932 is a great example: the economy declined by over 13% that calendar year, non-farm unemployment was 37%, and yet in June the stock market began to recover and went up over 137% in the following twelve months. If we wait until the economy begins to improve we may have missed the biggest gain in the stock market's recovery.

The last point I'll make is to address the subject of, "Should we have gone to cash last summer?" Though I have had people tell me they were leery of what was going on in the mortgage world and moved all or most of their money to cash, I did not see that coming. However, even if I had, the big question is, when does one go back. Very few have enough money that they can live on the interest and not worry about inflation so most will need to have some money invested in the stock market.

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