WURTS ASSOCIATES

MEMORANDUM

To: **Wurts & Associates Clients**

From: **Eric Petroff, CFA, Director of Research**

Date: **September 17, 2008**

Re: **Our Most Recent Credit Crisis**

Without a doubt, capital markets are being rattled profoundly. We understand that during such times of market stress our clients look to us for thoughtful insight and recommendations. So without needlessly getting into details, the following is our assessment of the situation.

Investors are simply discounting continued weakness in credit markets and the associated implications for future economic growth. This process has been ongoing since the middle of 2007 and continues as market participants slowly come to grips with the inevitable side effects of an historical expansion and reversal in liquidity.

The problem with periods of liquidity expansion is they create unrealistic perceptions of stability and continued expectations thereof. This encourages investors to undertake inordinate amounts of risk for the associated rewards. This is exactly what the leadership at Lehman Brothers, Merrill Lynch, and AIG did.

Of course every coin has two sides in that people also tend to extrapolate current poor conditions too far into the future. This is why capital markets rapidly deflate as investors collectively succumb to fear of loss and irrational pessimism. This herd mentality results in massive capital dislocations and a redistribution of wealth amongst market participants. It is during such times we should stop and focus our energies on what we know, what we don't know, and what to do based on limited knowledge and insight into the future.

Though it sounds presumptuous, we have a very good idea of what is going to happen in capital markets over the near term. Market participants will continue to discount the value of risky assets, meaning prices will fall and prospective returns will go higher to compensate for the additional perceived risk. This discounting will continue as more financial institutions fail, credit markets tighten, and the economy weakens as a result. Eventually valuations will become low enough that investors believe prospective returns offer sufficient compensation for bearing near term economic and market volatility.

In lay terms this means the market will without a doubt find a bottom. Thereafter negative economic news will have little to no effect because such events will have already been priced in. Typically capital markets reach these points well before economic activity recovers, and in fact tend to strongly rebound shortly thereafter due to renewed optimism.

What we don't know however are the specifics of this timeline. We have no way of knowing which institution will fail next, nor do we know how much further the market will decline as a result. Furthermore, there is no way to predict the prospective returns investors will require to accept near term economic uncertainty. So this combination of knowledge and ignorance creates a problem for institutional investors.

The most important thing we should keep in mind as fiduciaries is to avoid handing our wealth to other investors by acting irrationally during tumultuous times. The fact of the matter is our asset allocations are designed with these events in mind. We know full well capital markets will recede in value from time to time, and that those recessions are sharp and painful in nature. This is why we not only diversify our portfolios' risk exposures but also enact rebalancing guidelines. In other words, investment policies are designed specifically for these sorts of occurrences.

Practically speaking though, investors are faced with three basic options.

1. Abandon asset allocation policy and sell risky assets with the hope of purchasing them again at an unspecific point in the future at an unknown price, but hopefully at a cheaper, not higher price. This is market timing and will necessarily result in random results.
2. Ignore rebalancing guidelines and allow your portfolio's asset allocation to drift; or do a little market timing. Again, the results of market timing are unpredictable.
3. Follow investment policies and rebalance by purchasing risky assets as they become cheaper. Over the long term we can be reasonably confident this option will result in the highest expected returns of all three options. In fact, there's lots of evidence to support this conclusion.

Therefore, our recommendation is option #3.

We simply do not know how much farther the market may or may not fall. Moreover we have no way of predicting when investor expectations will reach a nadir (lowest point), or when markets will rebound. Therefore any recommendation to tactically abandon asset allocation policy will be shot in a dark. We just can't bring ourselves to do that.

More constructively though, we do know investors are frightened, that equities are becoming more attractive, and that we'd rather be on the positive side of one of the most massive redistributions of wealth in recent history.