



Volume 2, Issue 10

The (not so) Almighty Dollar

December 15, 2008

Monthly Newsletter and Update

Dear Valued Clients, Friends and Professionals,

The holiday season is doing its best to offset the worst three months of my professional life and the most depressing financial results for my clients in my 35 year career. There is a possibility we will enjoy a Santa Claus rally. It might be a little bit of cheer but it isn't likely to offset the dismal red numbers concerning equities in the box to the right.

We are now in a recession regardless of one's definition of the term. The various analysts whose newsletters and op-ed pieces I read have suggested the length and depth will be somewhere between 6 months to 9 years and moderate to severe. Economic news is not encouraging and it is likely that the unemployment rate, already higher than any since the early 1980s, is going to go up. Anecdotally, I am hearing from clients in various sectors of the economy that things are not looking good. Perhaps I should try to obtain some bankruptcy lawyer clients.

It is difficult to find reason for optimism amid all the doom and gloom but I have persevered. It is perhaps an example of optimism overcoming logic but I think we are close to the end. There are indications that the incoming administration is going to take thoughtful and effective action. Most of the economists that I respect are of the opinion that the government should take extremely aggressive and large steps to stimulate the economy without being overly concerned about inflation or the national debt. The causes of our current economic problems are deep and took the better part of 25 years to mature. It won't be easy, but I think strong corrective action will be good for the long term health of our society. In the mean time there will be some excellent opportunities to profit from the pain - and I think there are some already available.

Best regards,

Jeff Sprowles, CFP®

Intra-Quarter Update

- S&P 500 – domestic large cap
 - 9/30 to 12/15 (25.0%)
 - YTD (39.5%)
- Barclay Intermediate Gov Bonds
 - 9/30 to 12/15 6.0%
 - YTD 10.6%
- Morningstar Taxable Money Mkts
 - 9/30 to 11/30 0.2%
 - YTD 1.9%
- MSCI Barra Emerging Markets
 - 9/30 to 12/15 (28.5%)
 - YTD (54.8%)
- Jeff's Current Stock Outlook
100% of target

JEFF'S PICK:

FXI and EWH — These are the two ETFs that Jeff uses to invest in mainland China. FXI holds 25 large cap stocks. EWH holds 43 mid to large cap stocks including some real estate. All holdings are traded on the Hong Kong exchange. They are both down over 50% year to date and appear to be cheap.



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Market comments

Regular readers of this missive will note that the stock target is at 100%. The ratio of theoretical real yield of the S&P 500 Index to the 5 year U.S. Treasury Bond is close to its historic high. The market capital weighted price/earnings ratio of the S&P 500 Index is close to a single digit. On the other hand, if the recession is moderate to deep the market probably won't pick up with a strong trend until the latter half of 2009. Nevertheless, there is still significant cash that fled the market over the last six months waiting for a clear signal to get in. When it does, the market is likely to go up significantly and stay there. All of my client money that is in stocks is long term money. I think it prudent to risk some more down side volatility to make sure we enjoy the full recovery when it happens.

A significant allocation of my equity target is devoted to emerging markets such as China, India and Brazil. The dollar's recovery against foreign currencies over the last six months contributed to emerging markets doing even worse than domestic stocks. The history of these markets is of big swings. Also, their underlying economies are likely to stay positive even as ours lives through recession. When they come back they will outperform significantly as well so I am staying the course in this sector. Further, the dramatic increase in the U.S. national debt does not bode well for long term dollar strength. As a senior Chinese official noted in a recent interview with James Fallows in *The Atlantic*, the United States cannot take foreign investment in our debt for granted. Even though the equation that measures the value of the dollar against the Euro, Yen and RMB Yuan is one with multiple variables, as long as we collectively continue to live beyond our means and direct our best and brightest college graduates to investment banking instead of manufacturing, it is likely that our currency will continue to weaken.

FINANCIAL FABLES

Philip Manly Kunkelman is a fee only registered investment advisor and financial planner. He spent much of his three decade long career in financial services handling wealth management problems for affluent individuals and families. He developed quantitatively based processes for portfolio analysis and management that proved to be sound and effective. He was careful to match client risk tolerance to the likely volatility of their portfolios in a context of a financial model used to determine what risk and reward was necessary to reach goals. Philip had a reasonably high degree of confidence when he discussed likely range of returns with clients.

In 2008 Philip felt modestly confident about the stock market for the year. The deflation of the U.S. residential real estate bubble and subsequent destruction of major financial organizations that were involved with sub prime mortgages and associated derivatives such as credit default swaps and securitized mortgage pools trashed all of the fundamentals of investment behavior on which he had relied for the previous 20 years.



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"You have to think long-term. You can't afford to be old yet."

Most of Philip's clients were understanding and relatively unconcerned about the long-term although all but one suffered a serious reduction to their net worth. Philip had made it clear that investments in the stock market were for the long term and portfolios were designed so that it would not be necessary to sell in a down market.

Nevertheless, by mid-October it was clear to Philip that a fundamental change to the United States investment process was underway. The federal government was directly involved in banks and the few surviving Wall Street brokerage firms were going to be regulated in a different way. Philip believed that such a radical change had not been seen in the United States since 1933 when the government created the SEC, FDIC and the Glass-Steagall Act.

What should Jeff... er, Philip do to move forward in the best interests of his clients?



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SOLUTION

Philip has modified aspects of his practice in a way that does not require a complete overhaul of portfolios but acknowledges and reacts to the changes he perceives.

1. He spent time with two consultants to express, modify and fine tune conclusions about what impact the changes of 2008 will likely have on investments and economics.
2. Philip revised his range of return method.
 - a. He added the EAFE and Emerging Markets Index to his data base.
 - b. He started extending the range of data to include the most recent month end index numbers.
 - c. He created seven default portfolios for use as starting points.
 - d. He decided to use the range of return data as a starting point not as an ending point for making risk/reward and allocation decisions.
3. Philip obtained an objective way to measure risk tolerance.
 - a. Using this tool he now can recognize when a prospective client has a risk tolerance lower than that likely to be needed to meet goals.
4. Philip rewrote the financial model to provide more thorough risk testing.
 - a. Previously, models were tested against 5 year periods of poor performances such as 1973 to 1977
 - b. Philip installed Monte Carlo simulation logic in his model to be able to more thoroughly establish the likelihood of success for various options.
5. Philip has been meeting with clients.
 - a. To determine if the 2008 "out of range" results have damaged long term objectives
 - b. To determine short and mid term tactical changes if any.

Season's Greetings



To those who have tried to contact Jeff on his cell phone: Jeff's office is in a dead-zone, and sometimes calls do not go through. When that happens, please call the office number and not the 891-XXXX number. Thank you!