

SHARPER ♦ GRANITE



Optimal Portfolio Management

FALL
2008

The credit crisis exploded this quarter, prompting unprecedented action by the U.S. Government to attempt to stabilize the banking system.

Six months ago we explored the failing of one of America's five great investment banks, Bear Stearns. The gambling and leverage principles explained in "Learning from the Collapse of Bear Stearns", *Spring 2008*, played out for the other four major U.S. investment banks.

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Lehman Brothers went bankrupt; Merrill Lynch was taken over by Bank of America; and the final two, Morgan Stanley and Goldman Sachs, reorganized from investment banks into highly regulated and presumably less profitable commercial banks¹ with the former selling a 20% stake to Mitsubishi UFJ Financial Group of Japan, and the latter selling \$10 billion of itself, half of that sum to Warren Buffett.²

On October 3rd a new law allocated budget for the Treasury to purchase \$700 billion in troubled bank assets. This law removes some uncertainty as to how much help the government will be offering through this crisis. Please read below for the details of this incredible event and how it will affect housing and our economy.

Economic uncertainty is always the root of market volatility. Another element of uncertainty that will be resolved soon is the upcoming U.S. presidential election. We illustrate in "How Tax Rates Will Change" an estimate of how your taxes – income, capital gains, estate, and other – are likely to change under either possible president.

We are experiencing an extraordinary period in the markets, one that has built steadily over the last 18 months and is unlike any that has occurred in our history. At these times we urge investors to remain calm, review the tremendous history our U.S. financial system has endured, and stick to the original long-term objectives of retirement support, college tuitions, etc. Fear rules the day when long-term investors panic and make decisions that will hurt long-term performance and original goals. Pulling out of long-term plans in volatile times can lead to other risks such as increased exposure to inflation or currency fluctuations, and the risk of impacting retirement projections by missing the bull market rebound, which is usually strongest at the beginning. In the bear markets since World War II, stocks have recouped an average of 33% of the losses in the first forty days following the bottom.³

The greatest of all long-term investors, Warren Buffett, was moving billions of dollars *into* the market as fear was peaking in September, investing \$4.7 billion in Constellation Energy and \$5 billion each in Goldman Sachs and General Electric preferreds. But even Buffett insists that neither he nor anyone can predict market bottoms. In other words, stick to the basics, maintain strategy, dollar-cost average with regular deposits, contribute to 401k's, etc.

Through this period we are striving for greater than usual communication with our clients. Please feel free to call your Sharper ♦ Granite advisor to discuss the current financial situation in more depth and to understand how it is affecting your retirement or education fund projections.

Financial Markets Summary



Several standard measures of market fear and volatility reached all-time highs in September as fear spread from Wall Street to Main Street and some considered stuffing cash in their mattresses, literally. Banks lacked the confidence to lend to individuals, businesses, or other banks, and people did not trust banks to hold their money. Things were not getting any better at the beginning of 4Q08, the first week of which was the worst since the September 11th attacks.⁴ Crises of trust can be most serious and lasting for the markets.

Four money market funds, which are not insured by the U.S. government but are widely considered “same as cash”, actually closed or “broke the buck”, meaning that your dollar in that money market was no longer worth a dollar.

Volatility was unprecedented the week of September 15th. Four of the 25 most volatile days of all-time occurred that week. The VIX volatility index reached 42, the highest on record, on September 18th. Then, as the quarter was turning, measures above 47 were being recorded.

The average bear market descends 27% from peak to trough.⁵ Since the October, 2007 peak, the stock market, in fact, has fallen exactly to that level twice this chilling quarter, once mid-July when the government-sponsored entities (GSE's) Fannie Mae and Freddie Mac were taken over by the government, and again in September when Lehman went bankrupt, Merrill Lynch was bought by Bank of America, and AIG was taken over by the Feds.⁶

Interestingly, because of weakness in most of the mega-banks of the world this quarter, some of the safest asset classes were hurt as much or more than the stock market. Bonds of the highly capitalized banks are usually one of the safest places for investment capital. However, the usually-safe, bank-backed preferreds class fell 25% in 3Q08.⁷

The second half of September and early October investors were abandoning virtually every asset class, except those explicitly insured by the U.S. government. They piled into the safest investment of all, short-term treasuries, with such velocity that on September 17th the 3-month treasury yield fell to 0%. That is, investors' fear level was so high that they were actually lending the U.S. government money for free, in exchange for the safety of knowing at least they would not *lose* that money. With inflation factored, treasuries of all tenors (times to maturity) were trading with negative *real* returns (real returns subtract the inflation rate from the nominal interest return).

The S&P 500 Index with dividends added in finished -4.7% for the quarter ending September 28th and -16.1% year-to-date. Perhaps surprisingly, the leading sectors this quarter included financials (+5.6%), residential real estate (+3.4%), and REITs (+4.9%).⁷

The for-profit education sector soared again for the second straight quarter. In sour economic times, when unemployment rates rise, these companies profit from rising enrollment as displaced workers go back to school, making them excellent recession hedges. These stocks also do well generally over the long-haul. Our portfolio construction software values these twin characteristics, and thus, most of our Sharper ♦ Granite portfolios hold representative stocks from this sector.

While no education sector index investment products exist yet, Sharper ♦ Granite uses industry leaders Apollo (APOL), Career Education (CECO), Corinthian Colleges (COCO), and ITT Educational Services (ESI) in portfolios. They were up 33%, 18%, 37%, and 6% respectively during this difficult quarter.

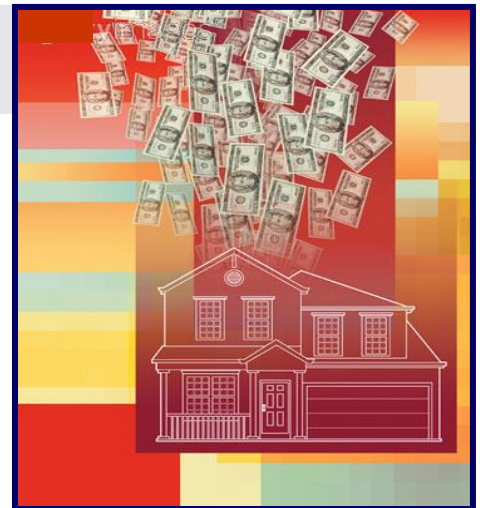
Meanwhile, only the safest of bonds, those backed by the U.S. Government, increased in value this quarter as the benchmark 10-year Treasury yield was pushed all the way down to 3.6% due to high demand. The Lehman Aggregate Bond Index was flat (bond price gain + interest payments), but this largely overstates the condition of bonds this quarter. This Lehman index is comprised 78% of super-safe treasury-level and AAA-level debt.⁷

In reality, bonds of all types below treasury-safe levels were demolished as a fear of lending drove the yields of most bonds through the roof. Two of the bond categories safest from default are municipal bonds and short-term, bank-to-bank loans. Municipal bonds (backed by the taxing authority of states and local governments) of all rating levels saw only 18 defaults out of 28,099 from 1970 to 2000.⁸ They are extremely safe. However, the spread between U.S treasuries and muni bonds reached the highest on record.⁹ Also, the spread between treasury yields and the rates that banks charge each other for overnight loans shot to record levels.¹⁰

The average of all Sharper ♦ Granite client portfolios returned -6.5% (net of fees) for the quarter ending September 28th. This compared with -4.7% return of the S&P 500 Index over the same time period. The risk level of the average of all Sharper ♦ Granite client portfolios was estimated to be 40% less than that of the S&P 500 Index.¹¹ ●

Analysis of Housing and the Financial Crisis: Where We Are Headed

At Sharper ♦ Granite we study risk constantly. Our framework for such is shared in “Balancing Portfolios to Minimize Risk”, *Summer 2004*, which can be read at www.sharpergranite.com. The risk category biting us now is rare – not the culprits we usually worry about – inflation risk, interest rate risk, or even oil price risk. We are currently being bitten by the rarest of the financial industry risks, liquidity risk, which is based on a lack of trust. Banks do not trust to lend to individuals, corporations, or even other banks. And in some cases, individuals do not trust banks to hold their money. Crises of trust in lending historically have been some of the most severe.



This threat was more common in the first half of the last century and is part of the reason even today that many bank branches and offices are housed in buildings designed to convey stability, with pillars or thick steel doors. Just walk along the row of banks in the downtown San Francisco financial district.

This crisis threatens to prevent individuals from buying houses, cars, or even going to college, and to stop some normally profitable businesses' operations dead in their tracks. It was triggered by a collapse in housing prices and highly leveraged bets by financial institutions that housing prices would not fall. As we will see, the housing market and the financial market are tightly linked.

First, a Lesson from the S&L Crisis

The savings and loan (S&L) crisis of the 1980s and 1990s offers some striking parallels to our situation today. Then, as in recent years, financial institutions faced decreasing regulation, aggressive competition and falling lending standards.

This resulted in a surge in risky loans, which ultimately led to bank failures when those loans went bad. Between 1980 and 1994, the Federal Deposit Insurance Corporation (FDIC) intervened with 1,600 Savings & Loan associations and took over 700 of those. The government suddenly owned about \$394 billion in sketchy loans and physical properties -- all manner of dogs and cats.¹²

To manage this, in 1989 the U.S. government created the Resolution Trust Corporation (RTC), which took over assets, held them, and then eventually resold them. The total cost of that crisis has been estimated to be \$160 billion, of which roughly \$125 billion was paid by U.S. taxpayers.¹³ Without the RTC, losses would have been closer to \$350 billion.¹² With confidence in the U.S. financial system badly shaken, investors fled financials from 1986 through the end of 1991. But over time, the creation of the RTC helped convince investors that the worst was over, and they eventually returned to the sector. By 1995, it made up 14% of the S&P 500 Index, up from 9% in 1990.¹³

History never repeats itself exactly, of course. Still, we believe a clear lesson from the S&L crisis is that when severe problems are plaguing the financials sector, the government often needs to step in decisively before investor confidence can be restored.

The \$700 Billion Dollar Treasury Fund

Congress recently passed the Treasury's plan to establish a \$700 billion fund, similar to the RTC but within the Department of the Treasury. The fund will buy troubled assets at financial institutions in the U.S. and abroad via a reverse auction process. That is, they will announce that they are buying a certain category and amount of distressed assets and then buy from whichever bank wants to sell at the lowest price. Thus, theoretically helping the most desperate of banks, securities and insurance companies.

The fund will hold these assets until the trouble has passed and then resell them. Thus, the \$700 billion, even if entirely used, would not be a cost but rather an investment for U.S. taxpayers. There is a strong likelihood that the fund could even make a profit for taxpayers as it did in the 1979 Chrysler rescue.¹⁴

Insurance: Banks, Schwab, and TD Ameritrade

FDIC Insurance: Banks pay premiums to have their customers' deposits insured in case of failure. While the FDIC reserves are finite, they are backstopped by the Treasury. That is, the FDIC can turn to the government for more money if needed. They then typically pay the loan back over time as premiums are collected. This is what happened in the S&L Crisis. The FDIC will be raising premium rates on its member banks this quarter to reflect the increasing risk.

Your bank deposits, including CD's, are insured to \$250,000 per institution as of October 3rd. Thus, to maximize your insurance coverage, you should not have any more than \$250,000 parked at any one bank. Also, money market accounts are not insured, though current action by the treasury may be changing this for a specific period of time.

SIPC Insurance is the same idea but is specifically designed for securities firms, rather than banks. SIPC insurance covers \$500,000 per account at brokers like Schwab and TD Ameritrade. In addition, TD Ameritrade carries another \$900,000 per account from Lloyd's of London, currently one of the most well capitalized banks in the world.

Of course, individual investments held at Schwab or TD Ameritrade hold the risk inherent to that investment, but not of the broker. That is, if Schwab were running into financial trouble, they could not reach into client accounts and steal their stock and bond investments.

Unlike the rest of us, the U.S. Treasury can borrow from the world at 2 – 3% for this investment. This low cost of capital makes their profit extremely likely. The government will use cheap money to buy quality, undervalued assets that no one else wants and then hold them for several years. This is exactly Warren Buffett’s strategy, and it usually works. In fact, Warren Buffett said he would happily invest \$7 billion alongside the Treasury if they would allow him the same terms.¹⁵

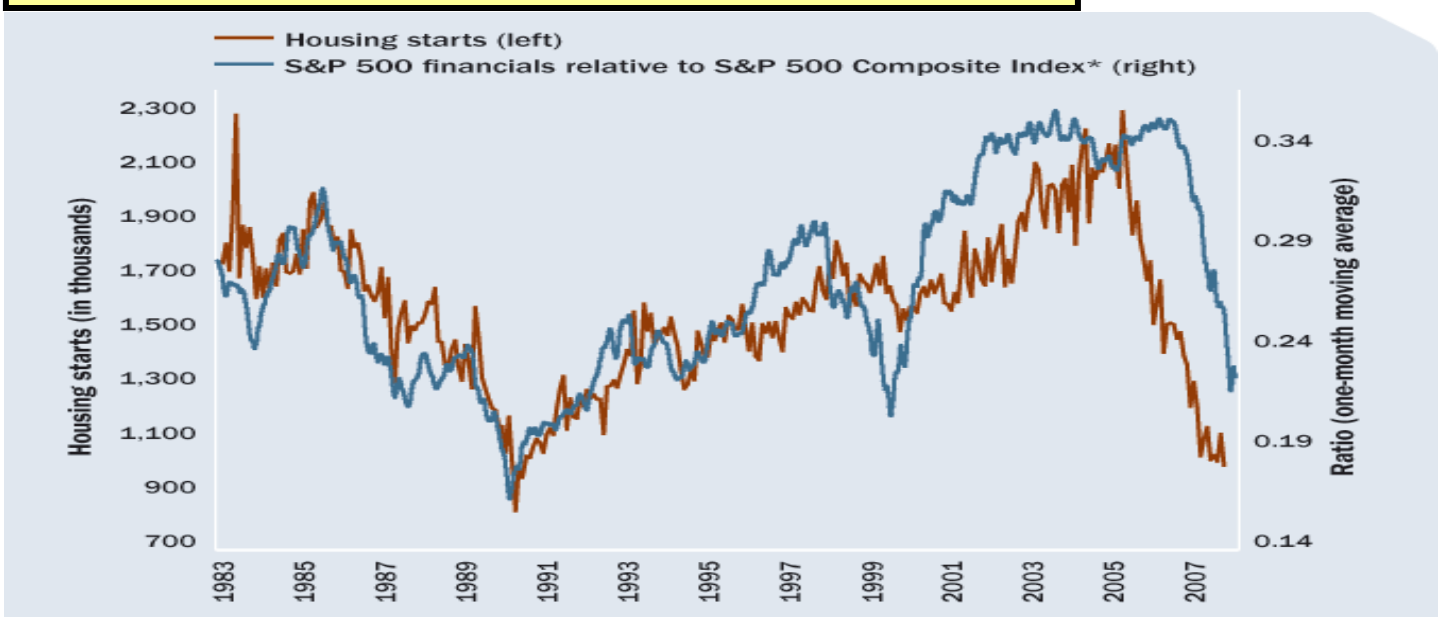
To pay for this massive investment, the U.S. Treasury will sell treasuries. At the present time this strategy fits well because there is far stronger global demand for U.S. treasuries than supply. This is a fortunate and self-correcting situation. Because investors around the world are worried, they want safe U.S. treasuries. The U.S. may now happily sell those treasuries and use the proceeds for the buyout fund.

Other government action included a Treasury request of up to \$400 billion to back up money market funds, and the SEC’s temporary banning of short sales (market bets that a particular stock will decline) for 829 named financial institutions though at least October 9th. There are also discussions about the Treasury making short-term loans directly to businesses in the massive lending class known as commercial paper. Commercial paper is an extremely important credit mechanism which many large companies use to fund their operations. Finally, more U.S. and global rate cuts are likely. On October 8th a global interest rate cut was orchestrated by several countries’ central banks.

A View of the Source: Residential Real Estate

While these government actions will help avert a much more severe lending crisis, the root of this situation is declining home prices. In fact, the relationship between the housing sector and financials has been a strong one throughout history.

*Strong Correlation of Financials and Housing Starts*¹⁶



Mortgages are typically banks' most profitable, but also potentially most dangerous products. Banks, after all, typically hold most of the risk that a borrower may not be able to pay. When the price of a home declines below the value of the mortgage as is happening now in some cases, then even if the bank forecloses and takes ownership it suffers a loss.

Thus, we want to keep special watch on key home price indicators. The most accurate indicator in our view comes from Princeton Professor of Economics, Gary Shiller. Here, we see the extent of the damage to date as well as potential hope.

The S&P/Case-Shiller data on a quarterly basis showed 2Q08 home prices plunging 15.4%.¹⁷ This looks like it may be the nadir in price decline *rate*, because monthly price decline data is now consistently improving. Nine of the twenty cities saw price appreciation in June. Home prices are falling, but less and less drastically.

Home Price Change in 20 Major U.S. Geographies ¹⁷



However, we remain cautious regarding this data. The housing inventory overhang remains. Also, the recent improvement may be because lenders already dumped their lowest-quality foreclosed homes earlier in the year. Also, most of the improvement is concentrated in the new-home market, which represents only 15% of the residential real estate market (vs. 85% for existing homes).¹⁸

The other challenge is that even homeowners with good credit are falling behind on their payments in growing numbers, even as the subprime market is showing its first tentative signs of leveling off. Estimates are that 70% of Alt-A borrowers exaggerated their incomes -- more than half of those by 50% or more.¹⁹

The percentage of Alt-A mortgages (one rung above subprime) in arrears has quadrupled since last year. There are about \$1 trillion in Alt-A mortgages outstanding and about \$855 billion of subprime loans, 16% of which are currently at least sixty days in arrears. These numbers allow us to estimate the total amount of potentially troubled mortgage debt.¹⁹ Even if one-third of all the subprime and Alt-A mortgages become distressed, that is \$610 billion, which could be completely covered by the U.S. Treasury plan, not to mention potential corporate, hedge fund and private equity buyers once the process has begun.

What to Expect

This analysis points to a few likely events. First, the actions of the Fed and Treasury should eventually help free up capital, facilitating bank-to-bank lending, corporate financing, and mortgages, but it will be a long and bumpy process. Along with this healing process, the home price decline should continue for some months but eventually stabilize, perhaps as early as mid-2009, with some geographies recovering more than a year before others.

The banking industry as a whole will remain weak, perhaps for years, but will bifurcate soon, with the weak banks becoming weaker and the strong banks, like Wells Fargo and JPMorgan in the U.S., and HSBC and Credit Suisse in Europe, becoming stronger with the benefit of access to cheap capital (with help of the Fed) and a steep yield curve. Steep yield curves are more profitable for banks as they borrow at low short-term rates and lend at higher long-term rates. Debt, preferred and common stock at these institutions will turn into long-term profitable investments.

Eventually, we will recover from this crisis. Those who have a need for cash within the next year should be cautious and avoid stocks. But for those with a long-term investment horizon, now is a unique opportunity to pick up quality undervalued assets and hold them, just as Warren Buffett does. ●

How Tax Rates Will Change

While the current banking crisis offers plenty of near-term uncertainty, investors must also weigh into their investment decisions and financial planning the tax effects of the coming election because Barack Obama and John McCain both favor changes to the current tax code.

Both want to cut income taxes for most. McCain's plan would add \$4.5 trillion to the national debt over the next ten years, compared with \$3.3 trillion for Obama's plan. The chart below shows the estimated income tax impact to individuals at different income levels.²⁰



McCain would cut taxes aggressively at all income levels. He wants to make the Bush tax cuts permanent, then cut taxes further by repealing the alternative minimum tax (AMT) and slashing the corporate tax.

Obama would also cut income taxes – and more aggressively than McCain for those earning under about \$66,000 per year. However, he would significantly raise taxes for those making over \$603,000.²⁰

Obama would raise the capital gains tax, probably to 25%. This is a change that would drastically affect investing

strategies. The incentive to hold everything from stocks to houses for more than a year would lessen. Thus, owners of stocks, real estate, or small businesses which have appreciated over past years, may rush to sell at year-end before the higher capital gain tax rate likely goes into effect.²¹

The estate tax exemption is another number that many are watching closely. Currently, the estate tax exemption is \$2 million per person, rising to \$3.5 million per person in 2009 and going to infinity (no estate tax) for “lucky” deaths in 2010. But then without new legislation the exemption is set to return in 2011 to \$1 million at a 55% maximum rate.

Estimated Income Tax Change²⁰

Annual Income	McCain Avg Change	Obama Avg Change
Over \$2.9M	- \$269,400	+ \$701,900
\$603k - \$2.9M	- \$45,400	+ \$116,000
\$227k - \$603k	- \$7,900	\$0
\$161k - \$227k	- \$4,400	- \$2,800
\$112k - \$161k	- \$2,600	- \$2,200
\$66k - \$112k	- \$1,000	- \$1,300
\$38k - \$66k	- \$300	- \$1,000
Under \$19k	- \$100	- \$700

Both candidates want to ensure this does not happen and will push legislation to raise the exemption and lower the tax rate. McCain prefers at least a \$5 million per person exemption with a 15% tax rate (plan on a higher rate as Democrats will control Congress in 2009). Obama wants a \$3.5 million per person exemption and a 45% tax rate.

Both favor simplifying the estate planning process by eliminating the need for spouses to build A-B trusts into their wills solely to capture the per person effect of the exemption. Furthermore, couples would not need to re-title assets to equalize their estates. When one spouse dies, the unused exemption would automatically pass to the survivor and be available for use when the spouse dies.

For more detail about how these tax changes could affect the way we manage your portfolio strategies, please contact your Sharper ♦ Granite advisor.

Other Key Tax Rate Changes^{22, 23}

Tax	2008 Current	McCain	Obama
Long-term Cap Gains and Dividends	15%	15%	20% - 28%
Estate	\$2M exemption/ person, 45% tax rate	\$5M exemption/ person, 15% tax rate	\$3.5M exemption/ person, 45% tax rate
Corporate Max Rate	35%	25%	35%

Third Quarter 2008 Economy Review

The current credit crisis will roil in the macro-economy and will likely be the event that moves the economy into official recession if it was not there before.

The Conference Board's Index of Leading Indicators fell sharply in July and August.²⁴ Goldman Sachs estimates unemployment, currently up to 6.1%, will reach 6.5% by the end of 2009.²⁵ Finally, the Fed may be running low on ammunition now that the Fed Funds target rate is only 1.5%. Even previously-strong developing nations have been feeling the squeeze of higher commodity prices and the U.S.-led global slowdown.



Our leading indicators below indicate imminent recession. Remember that the stock market consistently leads the economy by 5 – 6 months. That is, in the future looking back we should see that the stock market will have begun its next bull run 5 – 6 months after the National Bureau of Economic Research (NBER) declared the recession end-point.¹⁴

Leading Economic Indicator Summary

- ↑ **Market Cycle:** The average bear market lasts 10 - 16 months and declines 27%.^{26, 27} At quarter end the market was one year into the bear market and had already hit a 27% nadir.

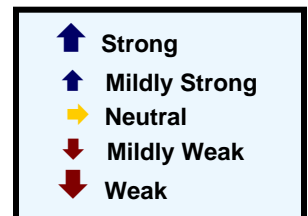
The fourth quarter is upcoming and tends to be the strongest of each year. November and December have been the strongest months for the S&P 500 Index since World War II.²⁸

Also, we continue to be in an environment of flat to decreasing interest rates. Interest rate direction is the most significant short-term influence on stock prices.²⁸ Market returns from 1955-2006 averaged 7.2% in the 12 months following rate increases compared to 18.5% following rate decreases.²⁸

- ↑ **Political Cycle:** We are in the fourth year of President George W. Bush's term. Traditionally, the third year in the presidential cycle is the strongest, but the fourth year is second best.²⁸ Since World War II, the fourth year of the presidential cycle has seen the S&P 500 Index post an average gain of 8.6%.²⁸ Eleven of the 14 post-WW II fourth years have been positive.²⁸ On average, the second and fourth quarters of a president's fourth year have been best, averaging 3.2% and 3.1% respectively.²⁸

In the short-term, since 1952 the stock market has rallied between Election Day and New Year's every time a new president has been elected for an average gain of 3.7% (24% annualized return).²⁹

- **GDP Growth:** Gross Domestic Product (GDP) is the official measure of the U.S. economy. It is a measure of all goods and services produced in the United States. 2Q08 GDP was revised to have grown at 2.8%, following 1Q08 GDP growth of 0.9% annual rate.³⁰ This implies modest growth, not yet in recession range. In fact, this represents the 27th consecutive quarter of expansion, or positive economic growth, since the official recession of 2001.



↓ **Purchasing and Manufacturing:** The Institute of Supply Management (ISM) Index, the key manufacturing indicator, fell off a cliff. The ISM Index had been hanging on as one final indicator of economic strength until September, when it suddenly plunged to 43.5, its lowest reading in seven years.^{31, 32} In the past, ISM readings of 43 – 44 generally occur during recessions.³³

↑ **Inflation Control:** The most widely accepted measurement of inflation is the Consumer Price Index (CPI). The core CPI, which excludes volatile food and energy prices, advanced at a rate in the upward range of that targeted by the Fed. January – July the core CPI averaged 2.6% and was just 2.2% this past quarter.³⁰

However, total CPI inflation with food and energy prices included rose at an annualized rate of 4.8% in the first quarter and 4.2% in 2Q08.^{B, 30} and was running at 5.6% in July.³⁵ This follows a 4.1% total CPI increase in 2007.³⁶ Thus, with food and energy factored, inflation has been running somewhat high.

However, inflation usually peaks during slowdowns, and with global economies following the U.S. into an economic slowdown, we can expect inflation to moderate in the near-term.³⁵

Looking forward, the TIP-Treasury spread is 1.5% at 10 years and 1.7% at 30 years, indicating that the market is betting on *only 1.5% inflation average over the next 10 years and 1.7% average over the next 30 years.*¹³

↓ **Oil Price Control:** While oil prices have risen approximately six-fold since 2001, this quarter they actually reversed, falling 24.3% this quarter.^{6, 37} Oil is a key input to so many business and consumer products. Its price movement can greatly affect consumers' abilities to travel and purchase leisure-time products. It also impacts the profitability of corporations that produce plastic containers, fly airplanes, drive trains, build trucks or manage hotels. Oil prices, while volatile, have such a strong influence on the overall economy that they must be watched closely and hedged when necessary. Every \$10 price change is worth about 0.2% in GDP.³⁸

↓ **Consumer Spending:** We are beginning to see true, genuine weakness in the U.S. consumer. This is ominous since consumer spending represents two-thirds of U.S. GDP.

Back-to-school sales are usually the second biggest retail season of the year behind the holiday season. 2008 back-to-school retail sales numbers were down 1.7% compared to last year.³⁹ This was the first drop in the last five years.³⁹

Our previously optimistic view of consumer technology sales is gone. While the weak dollar and booming developing economies were previously supporting overseas tech sales, the world now seems to be trailing the U.S. into a slowing period as the dollar rises. Dell mentioned in their recent earnings report that they are seeing this already.⁴⁰ The semiconductor index has dropped 40% in the last year.² Chip makers are cutting spending. Flat-panel and communications equipment sales are both down.⁴⁰

Consumer confidence showed signs of a rebound in 3Q08. After falling to 53 in June, its lowest level ever, the University of Michigan Consumer Confidence poll rebounded slightly in July then again to 61 in August.⁴¹ Rebounding consumer confidence, if it continues, would be a powerful sign. Troughs in consumer confidence have typically led to a 15% return in the S&P 500 Index in the next 12 months.⁴² However, the financial earthquake at quarter end may cut short that improving trend in confidence.

Finally, Moody's Investor Services is projecting 2008 to be the worst spending year since 1991.⁴³

↓ **Business Capital Spending:** The tightening credit environment is especially threatening to businesses' ability to fund operations or invest in new products. Early indications are that business IT spending is already weakening.⁴⁰

↑ **Investor Sentiment:** The bull/bear ratios continued to turn more bearish through the quarter as fear hit extreme levels in September.⁴⁴ The bearish sentiment in this measure is considered a positive leading indicator for the stock market as it suggests that worried investors may have already sold their stock positions, providing future potential cash flow into the market, especially with low interest rates making bonds an unattractive competitive investment. The depressed yield on the ultimate safe investment, treasuries, verifies that investors were indeed fleeing every investment with any risk at all.

Additionally, money has been flying out of equity mutual funds. \$50 billion flowed from U.S. mutual funds in June alone. The outflow from foreign mutual funds was even higher.⁴⁵ The ratio of cash to equities in the market surged to 31%, matching the level seen in 2002 after the tech bubble burst.³ Huge mutual fund outflows like this are often bullish, marking bottoms as in 2002. The outflows provide the potential energy for cash to flow back into the stock market at some point.

↓ **Corporate Earnings:** Corporate profits of the S&P 500 companies fell 22% in 2Q08 over the previous year after falling 16% in 1Q08. These earnings continue to be dragged down by the disastrous financial institutions sector.³⁵ However, non-financial S&P 500 companies through mid-year were actually reporting a 10% improvement in earnings.³⁸ We are likely to see the non-financials dragged down by financials as corporate lending stays tight.⁴⁶

↓ **Insider Trading:** Significant insider buying implies that managers have positive information about their company's outlook. Insider buying declined significantly this quarter to the \$20 million/day range.⁴⁷ In 2Q08 S&P 500 company stock buybacks declined 44% over the previous year and were the lowest since 3Q05.⁴⁸

↓ **Merger and Acquisition Activity:** M&A activity has fallen sharply in the U.S. and Europe. The total value of European private equity transactions fell in 4Q07 45% from the previous quarter to \$36 billion, its lowest level in several years.⁴⁹

September was the first month since April, 2003, without a single U.S. IPO.⁵⁰

The leveraged buyout (LBO) landscape has changed dramatically as the cost of capital to do risky deals has surged. The model of using heaps of cheap debt to take companies private is broken as banks and institutional investors are now demanding extremely high interest rates for risky loans. Through mid-August, the 2008 total U.S. buyout volume was \$67 billion vs. \$400 billion for the same 2007 period.⁵¹

Leveraged buyouts tend to be a bigger part of the deal flow when junk bond rates are low relative to corporate cash flows. That was the case from 2004 – 2007, but not now as risky lending has tightened.⁵² And for good reason. 43% of the debt issued since 2003 is now distressed (defined as yielding 10% or more above Treasuries).⁵² And the more recent the deal, the more likely it is to be distressed.³⁹ As of May, 75% of 2007 LBO issues were distressed and 48% of 2007 issues were distressed compared to 34% of 2004 deals which were distressed.⁵²

Finally, many private equity groups are warning clients about upcoming returns, including private equity giant, Apollo Management, which lost money on every one of its private equity investments in 1Q08.⁵³ ●

Notes and Acknowledgements:

1. Sanford C. Bernstein & Co. predicts that as a commercial bank with reduced leverage, Goldman's return on equity, a common measure of how efficiently capital is invested, will fall to 13% this year, from 33% in 2007, and hover near 14% or 15% for the next few years, September 27, 2008
2. "Buffett Deal at Goldman Seen as a Sign of Confidence", *New York Times*, September 23, 2008
3. Sam Stovall, chief investment strategist at Standard & Poor's in "Forget Logic; Fear Appears to Have Edge", *New York Times*, October 7, 2008
4. "One Problem Down, Many More to Go", *Barron's*, October 6, 2008
5. Haver Analytics
6. Sharper ♦ Granite analysis
7. Indexes used: SPDR S&P Financials (XLF), Dow US Real Estate (IYR), Vanguard REIT (VNQ), US Preferred Index (PFF), Lehman Aggregate Bond Index (AGG), Goldman Sachs Semiconductor Index (IGW), Goldman Sachs Oil Index (OIL)

Notes and Acknowledgements (Continued):

8. Moody's, "Moody's US Municipal Bond Rating Scale", November, 2002
9. Bloomberg, September 26, 2008
10. September 17th the three-month Libor in U.S. dollars jumped 19 basis points to 3.0625% -- the biggest jump since September 1999. The London Interbank Offered Rate, known as the Libor, measures the interest rate at which banks are willing to lend to each other overnight or for longer periods. On September 14th, the overnight rate hit a seven-year high of 6.4375%, more than doubling from Monday in what was reportedly the biggest jump on record. -- "Three-month Libor Marks Biggest Jump in Nine Years", *MarketWatch*, September 17, 2008
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