

# MARKET UPDATE



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### **What's the difference between a broker, financial advisor and an investment advisor?**

*The terms sound similar which can be confusing.*

*Brokers are paid commissions on trades you make and their primary responsibility is to their firm.*

*Financial advisors are paid to make recommendations but not necessarily to implement. They put together financial plans and are paid hourly fees or commissions for what they recommend.*

*Investment advisors provide an outsource solution to manage your money for you. They help develop your plan but are paid a percent of assets under management or commissions for investments they make.*

*LGA is an investment advisor and we are paid 100% as a percent of assets under management (e.g. no commissions).*

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## Q3-2007 HIGH-LEVEL MARKET UPDATE

As predicted in our last few newsletters, the market corrected in the 5-10% range, with the S&P 500 correcting downwards by 7.9% in early August, while Emerging markets and Europe declined by an even larger amount. However, the major carnage took place in real estate and mortgage-related investments, whose markets nearly imploded. Large banks, hedge funds, and mortgage lenders that were exposed to the mortgage market were impacted heavily. A number of mortgage lenders filed for bankruptcy (e.g. American Home Mortgage) while other larger players recorded significant losses and rapidly hiked rates in order to essentially stop products from being sold (e.g. Wells Fargo hiked 30-year fixed jumbo loans from under 7% to 8% overnight). At the big banks, a number of high-profile hedge funds had to close their doors or required bail-outs due to tremendous losses. For example, the Bear Stearns Alpha Fund, with over \$3B in funds under management, has declined by 27% in 2007, with half of that loss taking place in August alone. Their Global Equity Opportunities Fund declined 30% in just one week during August! Not only have these banks incurred large financial losses, but they have also been dealt a significant blow to their reputations as sound money managers. Additionally, with huge redemption requests from clients, these hedge funds are forced to sell anything they can get a good price on, creating a situation where the good investments are hurt along with the bad ones. These redemptions have caused an incredibly negative ripple effect on the investment market, leaving opportunity for companies and investors with the capital / cash on the sidelines to invest at depressed prices.

While market corrections are never fun, LGA active system clients (greater than \$150K in assets) were prepared for this decline, both in their portfolios and in their mental fortitude. Our diversified portfolios and defensive cash positions have been rewarded during this downturn, resulting in a lower decline relative to our market benchmarks. Additionally, the correction has reduced many overpriced asset classes to attractive levels where we have been able to get a good portion of our cash positions back to work in more aggressive investment assets, while still holding onto 8 – 12% cash to be deployed on any further declines. As indicated in previous newsletters this year, we have positioned LGA clients in conservative portfolios until market risk has diminished. Until we become more bullish, we will therefore trail the market when it moves upwards (e.g. Q2 and early Q3), and out-perform the market when it declines (current situation). This approach is consistent with our active system's dual objectives of long-term market-beating returns with minimum draw-downs during times of turbulence. Looking forward, we are growing more optimistic regarding the market's upside potential relative to risk. Remember, we want to be cautious when everyone is overly excited (e.g. Q2) and aggressive when everyone is fearful (e.g. now to the near-term future). While there may be more turbulence from the real estate and mortgage market fall-out, our fundamental models remain bullish and our technical models have moved from negative to neutral. If the market consolidates and our technical models turn from neutral to bullish, this will signal the appropriateness for higher risk-taking with our client's assets in the near to mid-term future. As always, we will continue to monitor markets and institute our risk management tools if further declines accelerate into an actual bear market.

## Q3-2007 HIGH-LEVEL MARKET UPDATE (CONTINUED)

For our buy-and-hold clients (less than \$150K in assets), losses have been equivalent or larger than the market's general decline during early Q3. Our real estate positions for these clients have taken a significant hit, and in one case we will be joining a class-action suit against American Home Mortgage who went bankrupt during the quarter, after repeatedly assuring investors that problems were contained and that the company was financially solid and thriving (our active system clients stopped out of this stock at much higher levels to limit their losses). Overall, our buy-and-hold clients outperformed their active client counterparts during the "hot" market in Q2, since we were more heavily ex-

posed to the market. However, we are declining more with these clients during the current Q3 correction, due to the additional market exposure and the nature of a buy-and-hold strategy. We have

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rebalanced the portfolios to buy real estate back at this significantly reduced level, and expect that the investment model will continue to outperform in the long-term.

Note: We feel compelled to remind our buy-and-hold clients that this strategy is more volatile than the active approach due to its

fully invested nature. While both techniques aim to beat their respective market benchmarks, the buy-and-hold strategy tends to beat the active strategy in bull markets (e.g. the last 3 – 4 years), while trailing in bear markets and over the longer-term.

Of particular importance, an active approach is not appropriate for smaller accounts given the increased costs of trading and their negative effect on returns. As clients save and grow their wealth, they graduate into the greater than \$150K net worth level, where it begins to make sense to implement the active system from an excess return relative to additional trading costs perspective. We encourage you to continue focusing on the long-term with your savings and investment plan so that you may graduate to the active program sooner rather than later.

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As always, we are available to discuss any questions you may have regarding our progress towards your investment and financial objectives.

Please call or email us to schedule a time to review.

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## COMPANY UPDATES

With the importance of a college education and it's rapidly increasing costs, many of our clients are looking for ways to save for their children's, grandchildren's, or relative's educations. The 529 plan is one of the most popular vehicles for doing so because it allows money to grow tax-deferred and is currently tax-free when withdrawn, provided it is used to pay for qualified educational expenses. Additionally, 529 plans offer an incredible amount of flexibility:

- Ability to make really small recurring contributions (e.g. there typically are no transaction fees)
- Ability to make very large contributions at one time which facilitates inheritances to transfer in one large donation
- Ability to easily assign a beneficiary, as well as change it in the future (e.g. if child #1 doesn't go to college, the plan can be transferred to another relative such as child #2, parent for continuing education, nephew, etc.)
- Provide a centralized location for relatives or friends to deposit gifts at birthdays, graduations, or other holidays and events.

Since each state offers a different 529 plan and most are open to out-of-state residents, your choices are vast. There are a number of things to consider such as costs, tax benefits, diversification and administrative burden. LGA has the experience to help you make the best choice, quickly setup an account, and start saving for your beneficiary's future education. As always, we are interested in helping our clients take care of their future financial objectives, with education being one of their most important goals. Please let us know if you have a 529 plan you would like us to manage or are interested in setting one up. You may contact us at [info@lgadvisors.com](mailto:info@lgadvisors.com).

Your LotusGroup Team,



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