



TRUTH AND CONSEQUENCES

- In many ways, 2008 was a very disturbing year. In addition to equity index losses that haven't been seen in many decades, it was a year of deception. The Madoff swindle was the latest exemplification of this theme. The first that comes to mind is the mortgage backed bonds using sub-prime loans. Amazingly these bonds were given a AAA rating by the likes of Moody's and Standard & Poor's (who are, incidentally, paid by the very institutions that benefit from high ratings). Then there was the idea of having people over 70 years old applying for life insurance that would be sold to a third party after issuance, in exchange for a substantial amount of cash. The fact that fraudulent and illegal practices were involved didn't seem to deter the people promoting these schemes. Each of these situations has something in common. The risks are difficult to foresee in relationship to the benefits claimed. They all require a belief in something that seems too good to be true. It is not the first time these kinds of things have happened, nor is it surprising that wealthy people are caught up in these schemes. The people that promote these ventures seek those who have the money to invest, and greed affects the famous and the mighty just like it does everyone else.

We believe, and have stated oftentimes in the past, that any investment that seems too good to be true must be investigated thoroughly. The problem is 1) determining the correct questions to ask and 2) being able to speak to the correct people to answer them. Critical Math Advisors has always stressed the importance of transparency. We encourage all of our investors to meet with our portfolio manager who will explain, in as much detail as the investor would like to hear, precisely how our decisions are made. There is no "black box". Everything we do is based on rules and rationality, designed to take emotion out of investing.

ARE WE DEPRESSED?

- The term "depression" has been bandied about in recent months. While depression is generally thought to mean a severe and prolonged recession, it has become synonymous with the Great Depression of the 1930s.

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In 1933, there were 30,000 U.S. banks; 4,000 of them failed that year. Those failures were caused by panicked investors who caused a “run on the bank.” The actions of the Federal Reserve in the late 1920s and early 1930s contributed to a 30% contraction in the money supply and to price deflation. Other contributing factors were the Smoot Hawley Tariff Act of 1930, which raised tariffs on more than 20,000 imported items. Many countries responded by increasing tariffs on U.S. goods, causing exports and imports around the world to fall by more than 60%. As if this wasn't enough, a prolonged drought and poor farming practices caused enormous upheaval. By 1933, unemployment rates reached 25% in the U.S., and it is estimated that real GDP decreased by about 30%.

Compare all that to the 7% + unemployment rate today and a decline in GDP of about 0.5%. As of October 31<sup>st</sup>, 15 U.S. banks have failed this year. Where we go from here is anybody's guess, but any comparison with the Great Depression has no basis in fact.

## THE BEAR FACTS

- From 1926 through 2008, there have been 13 U.S. stock bear markets. Ten of these coincided with a recession. The average magnitude of the decrease in stock value, as represented by the S&P 500, was around 39%. The worst occurred between 1929 and 1932 when stocks fell 86%. The longest started in 1937 and lasted 61 months. The mildest took place in 1990, with markets down 20% over a 3 month period. However, one year after the low point of each bear market (not including the current bear market, since that time period has not come to pass), the average return has been PLUS 46%. Of course, it must be pointed out that a market decline of 39% which is followed by an increase of 46%, would still result in a net loss of 11% because the increase starts from a lower number. Obviously, it is extremely advantageous to avoid as much of the average loss as possible and yet still enjoy as much of, or even more than, the average gain. Not easy to do, but a worthwhile objective.

PEERING INTO THE FUTURE?

- It seems as though a massive government program is in the works. Early indications suggest something like \$300 billion in tax cuts, all of which the President-elect had spoken of in the past, and as much as \$1 trillion in stimulus programs focusing on infrastructure, education, the environment and housing. Of course the devil is in the details, and until those are forthcoming, no one will know precisely what will be authorized.

Keep in mind that in order for spending of this magnitude to take place, bonds have to be issued. Someone has to be willing to buy those bonds, thereby lending that money to the U.S. government. With current interest rates low, that may require quite a selling job. It also must be pointed out that federal spending of this magnitude, which is in effect printing money, almost certainly will have an effect on the dollar and could have significant future inflationary ramifications. If that is so, it could be a very bad environment for bond investors going forward. As interest rates rise, bond prices fall, and total returns generally suffer. Bond total returns have done well in the past decade as interest rates have fallen. A substantial and significant change in the direction of interest rates in the future could be problematic. Please keep in mind that while we do a small amount of investing in high-yield bonds, and as an advisor to individual clients have sometimes assisted them in the purchase of no-load municipal bond funds, we are NOT bond managers. We ARE primarily equity managers, meaning that we invest in stocks and stock indices. For those of you who have bond investments, it might be appropriate to seek the advice of competent bond managers to see what strategy changes you might want to consider in that arena.

ADAPT OR PERISH

- Scientists believe that between 95% and 99.9% of all of the species that have ever existed on planet earth have gone extinct. The ones that survive are those that are able to adapt to a new and different environment. Critical Math Advisors uses this concept of adapting by allocating the assets we manage according to the environment in place at any given time. People have asked us how we have been able to use our adaptive allocation models to reduce losses in 2008 by roughly half

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relative to the S&P 500. The answer is that our rule-based mathematical models are designed to adapt to whatever environment presents itself and to invest in those segments that present the optimum risk-reward profile. These systems invest cautiously when risk is deemed to be highest and most aggressively when risk is deemed to be lowest. We believe that being able to adapt to current environments will be more important in the years ahead than ever before.

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