Perryman Financial Advisory, Inc.

Three Forest Plaza
12221 Merit Drive, Ste. 1725
Dallas, Texas 75251
Phone: (972)770-4800
Fax: (972)770-4888

Is It Different This Time Or Will The Gloom Subside?

If the financial news has you hanging your head and thinking about hiding your money under the mattress, turn off the TV and take a deep breath. We've been here before.

Breathless talk of bank bailouts, the collapsing dollar, record oil prices, and mounting foreclosures has many investors nervously eyeing the safe haven of CDs, gold, and low-yielding Treasury bonds. Yet while a well-diversified portfolio might include some of those assets, overemphasizing them could carry a high cost in terms of lost opportunities and potential long-term losses.

It's hardly a secret that our current economic woes are linked to what had been a phenomenal rise in home prices that started during the late 1990s and gained momentum after the Sept. 11, 2001, terrorist attacks. Spurred by historically low interest rates and other factors, inflation-adjusted home prices rose 85% between 1997 and 2006, according to Yale University economist Robert Shiller, who developed the S&P/Case-Shiller Home Price Indices in the 1980s. It was the biggest national housing boom in U.S. history, and historic booms tend to be followed by historic busts. According to the S&P/Case-Shiller Home Price Indices, median home prices fell 8.9% nationwide in 2007, and that has sparked an explosion in foreclosures, a pervasive credit crunch, a slump in earnings for financial institutions, and plunging consumer confidence.

Financial stocks, now volatile and significantly off their highs, had been roaring ahead for years, helped along by the popularity of mortgage-backed securities. As home prices rose, mortgage activity soared, and banks repackaged bundles of home loans to sell to other investors. By December 2006, the stock of financial companies had bubbled up to account for a record 22.3% share of the Standard & Poor's 500 stock index—almost 10 percentage points higher than in December 1999. But many of the bundled mortgages were of the notorious subprime variety. When the housing market cooled, defaults on those loans began, and soon financial institutions were swallowing huge losses. Their share prices plunged, and by April 2008, financial stocks were back down to a 17.2% share of the S&P.

As often happens when a bubble bursts, many investors found themselves over-concentrated in the hardest-hit sectors. Their financial holdings, which had been growing rapidly for years—and thus had come to make up a disproportionate share of those investors' portfolios—suddenly fell off the table. But the broader market has also suffered. The Dow Jones industrial average, after reaching an all-time high of 14,164.53 on Oct. 9, 2007, fell to below 11,745 by March 10, 2008.

A similar chain of events occurred during the early 1980s. Energy stocks, which had comprised only 15.7% of the S&P in 1970, surged to a whopping 28.2% weighting by 1980—and then plunged to 11.6% in 1985. That rise and fall was mirrored by the boom and bust of technology shares in the late 1990s. The high point came in August 2000, when information technology stocks accounted for a full one-third of the S&P 500. Then that bubble also burst, and the weighting for those stocks plummeted to 14.3% by September 2001.

While many investors suffered losses when those bubbles popped, the economy soon recovered, and it will happen this time, too. There's no way to know exactly when that will occur, but the point is to remain invested and diversified. That lets you take advantage of lower prices and puts you in position to benefit when the market inevitably turns upward.

Think about which investors had the best results during past bubbles. Was it those who panicked and fled the markets after the bubble burst—or those who made short-term adjustments but stayed invested and bought more while prices were low?

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Market Watch

	7/28/2008	YTD
DJIA	11,131	-16.09%
S&P 500	1,234	-15.96%
NASDAQ	2,264	-14.64%

By The Numbers

BAD MONTH - The S&P 500 fell 8.4% in June (total return), its worst 1-month loss since the stock index dropped 10.9% in September 2002. The 2000-02 bear market ended just 9 days later on 10/09/02 when the S&P 500 bottomed at 777 (source: BTN Research).

UPS DURING DOWN - The S&P 500 was down 13.1% (total return) over the 1-year ending 6/30/08. However during this 12-month period, the stock index has had 2 separate "bear market rallies," each of which produced total return gains of at least +11% (source: BTN Research).

For the Referrals...

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