



Registered Investment Adviser

January 10, 2008 Commentary
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S&P 500: 1420
NASDAQ: 2488
Gold: 895

“No generation can contract debts greater than may be paid during the course of its own existence.” –*Thomas Jefferson, in a letter to James Madison in 1789*

Great Entries, Terrible Exits

The above title pretty much summarizes the year. We did a great job catching stocks near intermediate low points but a terrible job protecting profits. In a secular bear market, one where the prices trend sideways but can manifest itself as a roller coaster ride along the way, the only way to make real money is to take profits when you have them. I’ve been talking about the secular bear and the need to take profits in the broad U.S. markets but made the mistake of thinking the resources area would avoid panic sell-offs. Don’t get me wrong, over the long term the resources sector will have little correlation to the broad markets but sadly, this year, during the most volatile down-moves in the broad markets, the resources followed. Fortunately, for the last week of the year and first week of 2008, resource stocks have bucked the recession-fear-stricken U.S. stock markets. Year to date the S&P is already down 4% while we are break-even.

As a result of all this choppy action, mimicking the DOW and S&P, our clients achieved average 2007 returns of 4.6% after fees. Yes, this is favorable when considering these investment accounts are, on average, limited by policy to a maximum of 60-80% stocks and the price performance of the 100% stock S&P 500 Index was up only 3.5% (the total return including dividends was 5.49%) but when you consider the gains we had earlier in the year it is disappointing.

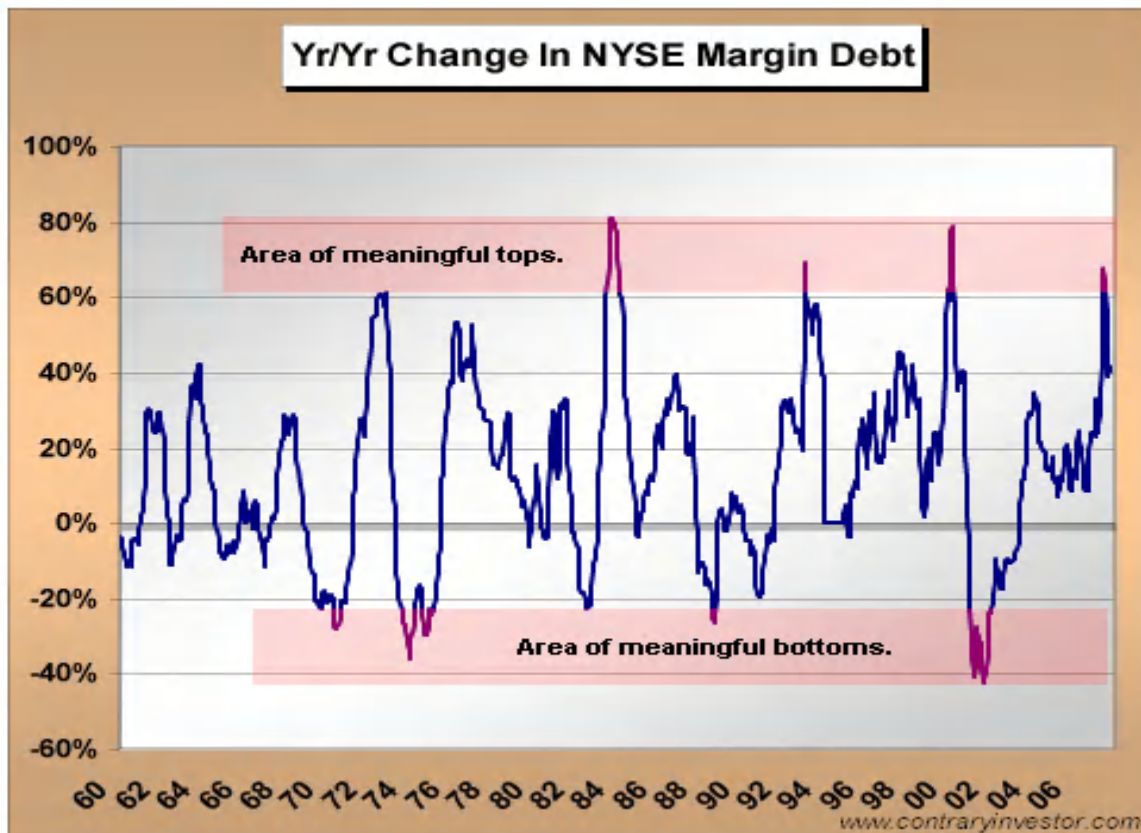
The good news is the entry strategy is incredible. We rarely bought a stock which did not at some point have a 10%+ profit. The better news is that we are adjusting the exit strategy such that we will rely on empirical exit points rather than dynamic, technically driven exit points. **To put it simply, I think going forward we will do a better job of protecting hard-earned profits.** The price we may have to pay is taxes on short term gains and the fear of “missing out” on further upside as we preserve a percentage of our profits. This is a small price to pay to miss a big hit in the accounts which is what I believe is in store for those who take the next year or two and “buy and hope” things go

up with no exit strategy at all. Tax consequences should always take a back seat to capital preservation when making investment decisions. Fortunately, most of my clients achieved their above-market returns with very little tax liability.

Is the Top In for U.S. Markets?

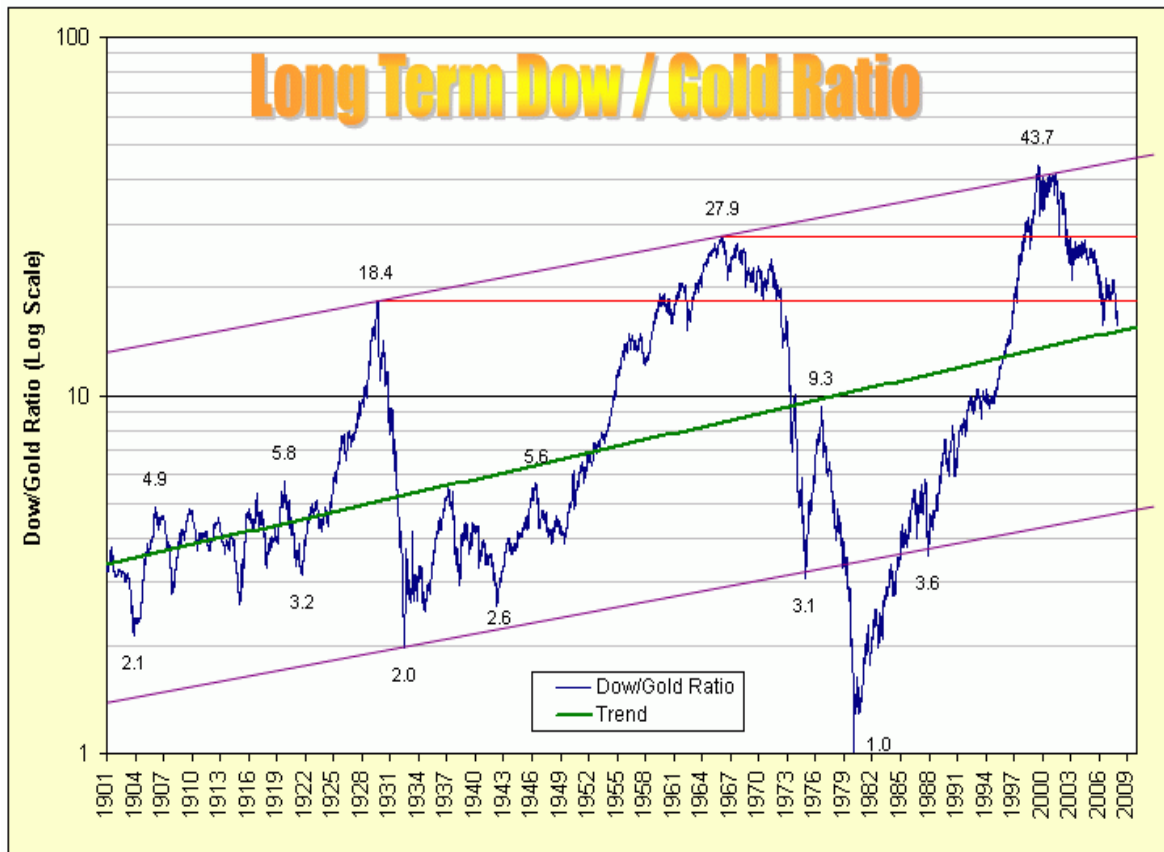
Below is a great chart from ContraryInvestor.com. It demonstrates the importance of tracking margin debt as we do in the indicators below. If you've ever read the description below you'll know that rapidly increasing margin debt, a manifestation of avarice in the market, is often a precursor to a top.

Margin debt is money owed against stocks owned. For example if you own \$10,000 worth of stock, depending on the stock you may go out and buy up to another \$10,000 worth of stock using the first stock as collateral. Because you are leveraged, price swings are magnified when translated into the net value in the account. Thus, one who borrows on margin to buy stocks is taking on more risk than just plain buying stocks. Risk tolerance can be measured in many ways, but this is a good real-time way to gauge the level of risk tolerance inhibiting the markets. When moods change more and more dramatically you tend to see extremes. In this case, when the level of NYSE margin debt increases in any given month by more than 60%, we typically see market tops. Obviously there are many other items to consider (see Indicators below) but given the state of the other items, I'd not bet against this indicator for the time being.



Courtesy of www.ContraryInvestor.com

Another Indicator is our most simplified Financial Asset/Real Asset Ratio: the DOW/Gold ratio:



Courtesy of Fred's Intelligent Bear Site: <http://home.earthlink.net/~intelligentbear/com-dow-au.htm>

The peak ratios of 1929, 1966 and 2000 coincided with the peak of a long drawn-out credit expansion as more faith was put into financial/intangible assets versus real assets. It seems humans are determined to create and manage their own money despite the unshakeable inability to manage it properly. The trough ratios of 1932 and 1974 coincide with peaks of human fear of the current system which they created but somehow could not foresee. The trough is coming-and the sooner we realize that the better.

Our mission is to maintain upside exposure to financial assets but remain grounded in an anti-inflation, capital preservation strategy. So far it has worked well as accounts we manage are policy-limited to 60-80% stocks and yet have done well to keep up with 100%-stock U.S. markets. And there have been numerous times, such as now, when U.S. markets are down and our clients are flat or up.

When will U.S. Markets be a “BUY”??

The following chart is a must for the year-end *Commentary*. This chart tracks the ratio of Prices-to-Earnings, or PE on the S&P 500 Stock Index. This ratio simply tells us how many years of profits investors are willing to pay in advance to own a company, or in this case, a broad index of companies.

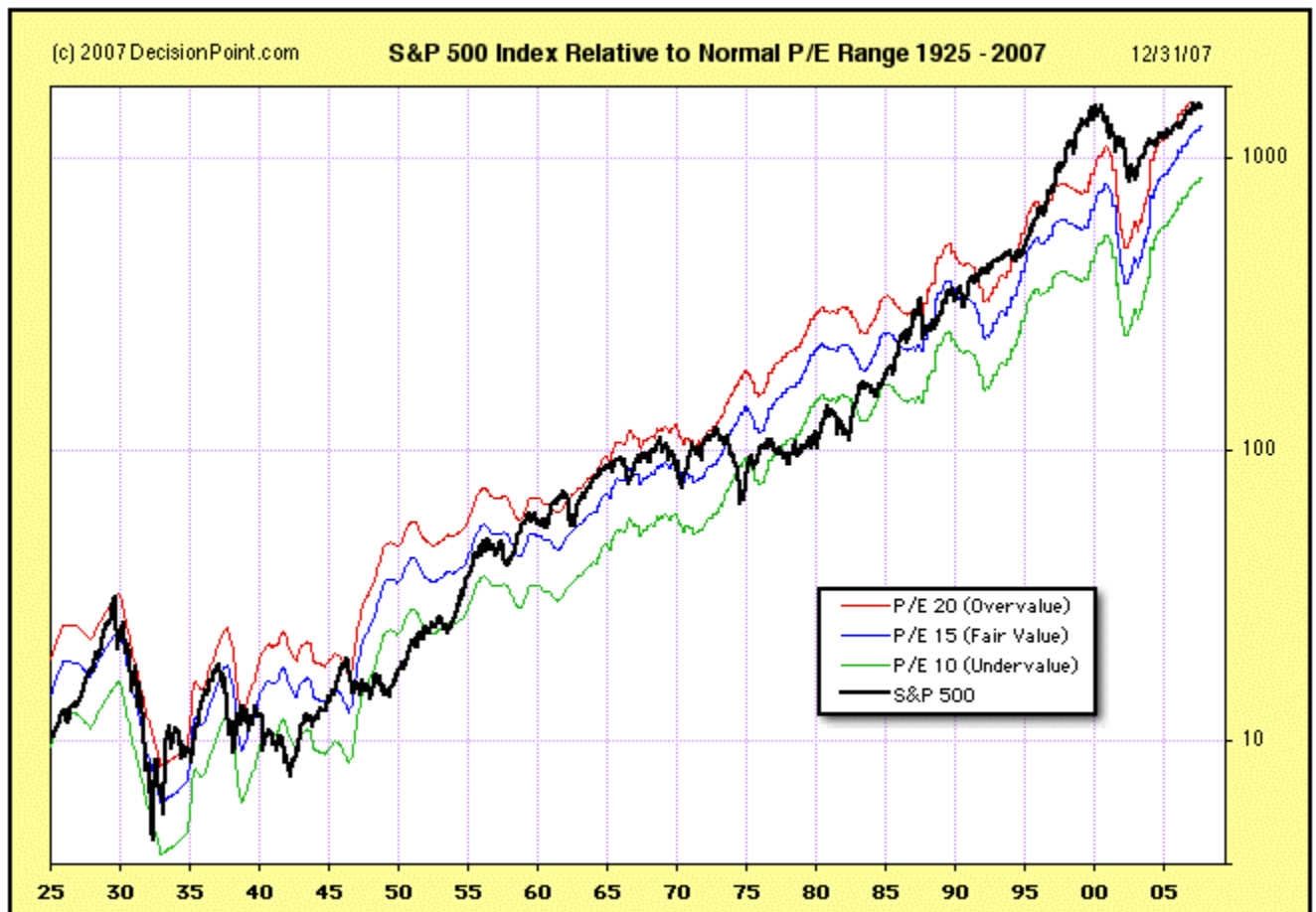


Chart courtesy of www.decisionpoint.com

The chart above illustrates the PE cycle over the past 82 years. The market value is in black while the PE range is illustrated using green (where the market would be if the PE=10), blue (where the market would be at fair value, PE=15) and red (where the market would be at a PE=20). You can clearly see that over time whenever the PE exceeded 20, it always reverted back to a PE of 10 or below.

The stock bull of 1982-2000 saw the S&P 500 go from 105 in July 1982 to a high of 1553 in March of 2000, an increase of 1478%, or about 15X. The PE ratio went from about 8 to 36-about a 4.5X increase. So without valuation changes the market climbed only 3X. In other words as the market grew, investors became more risk-tolerant and voted that way by paying more for earnings than before rather than becoming more risk

averse as prices soared. Currently the PE is about 18 while the market is at about 1400. I believe we could experience further decline as the S&P PE comes into parity with its growth rate. That is how you get to a bear market bottom as we saw 1982 when the PE was only 8. I'm not sure what profit expectations were then but the yield was 8%, justifying an 8 PE. I bet there was a positive growth rate expected but after 15 years of little growth (1967-1982) in the index there was also little optimism.

As you can see, rather than look at absolute price levels to determine when the U.S. markets are a "buy" for another 15-20 year bull run, we use relative valuations points. Using these tools, when the PE is near 10 and the yield above 5% we'll look for the "buy" signal on broad markets. In the mean time, we can certainly invest anywhere on a case-by-case basis if it meets our parameters.

The Indicators

"When Fear is at its height, Buy; When Greed is at its height, Sell" –among others, my father, J.M. Gore Friedrichs. With these indicators, we try to assess the current levels of "greed" and "fear". At times, we have contradictory readings and we simply balance them out to assess the current market environment. The best actionable points are when most or all of the indicators are in line.

Contrarian

<u>Indicator</u>	<u>Greed</u>	<u>Fear</u>	<u>Current/Direction</u>	<u>Indication</u>
NYSE Bullish Percent	>70%	<30%	28.31*/Down	Bearish
AII Sentiment				
Bull/Bear ratio	>2.5	<1	.47/Flat	Bullish
NYSE+NASD				
Margin debit balances	>160B	<100B	\$379B-Nov-07/Down	Bearish**
Savings Rates	<5%	>12%	-.5%/Down	Bearish
Mutual Fund Cash	<7%	>12%	4.5%/Flat	Bearish

<u>Valuation Indicator</u>	<u>Greed</u>	<u>Fear</u>	<u>Current/Last here</u>	<u>Indication</u>
Price/Earnings Ratio	>20	<10	17.80/Flat	Bearish
Dividend Yield	<3.5%	>6%	2.09%/Flat-Up	Bearish

<u>Monetary Indicator</u>	<u>Bullish</u>	<u>Bearish</u>	<u>Current</u>	<u>Indication</u>
Yield Curve Spread	>3.5%	<0	1.15/Up	Bearish

* The last comment I sent out before this recent decline talked about how this indicator had finally reversed from above 70% where it was overbought.

** Both June and July 2007 saw margin balance increase 60% Year over Year. With Margin Balances so high we are still vulnerable to declines that accelerate for the reasons discussed above.

Why These Indicators?

NYSE Bullish Percent: This great indicator I get from Dorsey Wright and Associates www.DorseyWright.com headquartered here in Richmond. This indicator tracks the percentage of stocks on the New York Stock Exchange currently on buy signals. Generally, the higher the number, the more buying has been done prior to the point of measurement. This could be an indication that less and less buying power remains out there, so at readings above 70%, we become cautious as the inevitable cycle of cash flowing in and out of the markets progresses. At levels below 30%, we become aware that a very good buying opportunity may lie ahead as most investors have probably already sold and are holding cash to fuel the next run.

AII Sentiment Bull/Bear Ratio: A weekly poll is conducted by the American Association of Individual Investors - what we call the individual public investors. This is a reliable indicator of the sentiment of individuals who are considered more emotional and less sophisticated than the “big money” investors. Since generally we don’t trust the emotions of the individual, this secondary indicator tells us when caution is warranted with high Bull/Bear ratio readings. Likewise, low readings can portend buying opportunities as markets tend to rally once the last little guy has bailed.

NYSE + NASD Margin Debit Balances: This is a monthly posting at the National Association of Securities Dealers’ (NASD’s) website telling us how much is currently being borrowed to own stocks. These are investors who actually borrow money to buy stocks and high readings generally indicate a frothy environment. The reason this is of particular value is that once the market turns, margin calls cause these borrowers to dump stock more rapidly in order to repay loans; thus, the risk in the market grows at something more like an exponential rate as these debit balances grow. Low debit balances indicate that these risk-averse investors have finally caved and now are flush with cash and fresh borrowing power, and thus, buying power.

Savings Rate: This is the national savings rate and is gleaned from the U.S. Personal Income and Spending monthly report. My view is that the lower the savings rate the less disposable income with which the emotional public can use to add to stocks. A higher rate, to me, indicates more reserves on tap to fuel a strong bull market. From a contrarian standpoint, this indicator also tells me how optimistic John and Jane Q. Public are about the future. Low savings rates indicate high levels of optimism and probably a correspondingly high level of risk tolerance. This can foster an inclination among investors to count on and indeed borrow against “future dollars”, which tells me to be careful.

Mutual Fund Cash: This is the level of cash held in mutual funds. Generally, less than 8% is bearish and greater than 10% is bullish. I go a little further and like to reduce my risk by waiting for buying opportunities closer to 12% cash and for selling opportunities at less than 7% cash. This works the same way as the savings rate except that this cash is

professionally managed money ready to be put to work. Generally, the more cash available, the better.

Price to Earnings Ratio (P/E): The historical average is around 15. We also call this fair value. There are many justifications in certain periods of time to accommodate higher levels, but the key I focus on is the historical tendency over decades of market action for this ratio to gravitate toward its mean of 15. Specifically, greater than 20 represents extreme overvaluation (proceed with caution) and less than 10 represents extreme undervaluation (back up the truck because the next 15 years should be good!). I use the P/E of the S&P 500, which represents 500 companies across the economy. P/E's are available on The Dow and NASDAQ as well. Bear markets usually bottom with P/E's around 8.

Dividend Yield: Again, using the S&P 500, this represents the amount of real money being distributed to shareholders as a percentage of their investment (the stock price). The historical average is around 4-5%. The higher the market goes, assuming a fixed dividend stream, the lower the yield. The lower the market goes, the higher the yield. Bear markets usually bottom with yields around 8%.

Yield Curve Spread:

This indicator tells us the difference, or "spread" between yields (compensation for risk) being paid on short-term funds (three-month Treasury Bills) and long-term funds (30-year Treasury Bond). Normally, the curve is upward sloping; meaning investors are expecting more compensation for the risk of inflation arising over the long term. This implies an inherent confidence in pricing power, generally speaking, which bodes well for the economy and stocks. An inverted yield curve (spread<0) is a condition that exists when short-term yields are greater than long-term yields.

Conclusion

The bear market in stocks which began in 2000 and the gold bull which began in 2002 do not seem to be over. We will continue to seek the best reward/risk ratio for our clients as we navigate these ever-complicated global imbalances. So far, our performance for under-weighted portfolios has been very strong in both up and down markets so we have confidence we are doing the right thing.

Again, Happy 2008 to all!!! Please do not hesitate to contact me with any questions.

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