FAI Advisors, Inc.

Monthly Investment Commentary

October 2008

Special Edition

September and the first part of October 2008 are turning out to be one of the most volatile periods in the markets, across all types of assets. In writing this commentary, the markets are down for an unprecedented 8 days in a row. Watching these daily market movements accomplished nothing in the big picture, but it sure makes quite depressing news. We all have our monthly statements for September, and frankly it is frightening. Our team is hoping that we can address some things with you that all of us are wondering about right now.

Fear and greed are competing emotions when it comes to our markets, and the fear factor currently has the upper hand. We read something recently that summarized what has brought us to where we are in this current economic crisis:

- This was brought on by willful disregard of common sense financial realities on the part

	September	YTD
Large Cap Benchmarks		
Vanguard SP 500	-8.90%	-19.30%
Russell 1000 Growth ishares	-11.60%	-20.30%
Russell 1000 Value ishares	-7.30%	-18.90%
Nasdaq (QQQQ)	-14.58%	-23.33%
Dow Jones Indust (DIA)	-5.90%	-16.88%
Small Cap Benchmarks		
Russell 2000 Growth ishares	-11.30%	-15.30%
Russell 2000 Value ishares	-4.70%	-5.40%
Other Benchmarks		
Vanguard REIT Index	-0.10%	1.80%
Vanguard Total Intnl Stock Idx	-13.10%	-29.20%
Vanguard Total Bond Idx	-1.10%	0.70%
Merrill Lynch High Yld bond Idx	-8.30%	-10.60%
Citigroup World Govt Bond Idx	-1.20%	1.90%
DJ-AIGCI (Commodity Futures)	-11.50%	-8.00%

	10/6/08	10/6/07	% Chg
Consumer Rates			
1 Year CD Yld	1.96%	4.05%	-51.60%
30 Yr Mortgage	6.08%	6.38%	-4.70%
Prime Rate	4.50%	7.75%	-41.94%
Commodities			
Crude Oil	88.95	80.28	10.80%
Gasoline	3.68	2.75	33.82%
Gold	903.24	715.65	26.21%

* Source: JP Morgan Weekly market recap

of borrowers who bought more home than they could possibly afford;

- by lenders who applied ridiculously lax standards and made loans to people who couldn't possibly afford them;
- by investment bankers who packaged them up and pushed them as safe and leaned on ratings agencies to give them high ratings;
- by ratings agencies who gave high ratings to securities they didn't properly understand;
- by institutional investors around the globe who bought these securities to get just a little higher return than they could safely get elsewhere so as to pad their bottom lines and bonuses;
- and by government authorities who almost totally failed to regulate this massive balloon in debt securities.

What is going on?

Regardless of why or how this happened, the real question is, what is likely to happen from this point forward in the short term? The "bailout" package, that seems like a distant memory, was supposed to provide some liquidity to grease the wheels of the economic system. At this point, the effect has been negative, but over time it will make a substantial difference. Confidence in the short term has been further eroded to the point where even the slightest news causes a 500 point decline in the Dow. Our economy is left to work it's way through an environment of reduced consumer spending, a damaged housing sector, lack of confidence in banks lending to one another, etc. The issues will work their way through the system, as they always do, just not as quickly as we would like.

In this current recession, the common question is: How long will this last? According to JP Morgan Asset Management, there have been seven (7) recessionary periods since 1961. The data on these recessions are as follows:

The average recession lasted 11 months, stocks bottomed 5 months prior to the end of the recession and the market fell on average 27% from it's high. Finally, during these recessions, unemployment rose 2% from their pre-recession levels.

As of October 9, 2008, the Dow is currently 40% below the high in October 2007. As we are seeing in the stock and bond markets, downward movements in prices occur as confidence is reduced. What is different from the last bear market cycle of 2000-2002 is that many assets outside of the stock market are being sold off due to wide spread lack of confidence. This results in finding very few places to hide during

this time of falling prices, including the bond market. Furthermore, the activity of "short selling" by traders is contributing to the large swings in the index.

Portfolio Concerns

As of June 30, 2008, the overall markets seemed to be handling the credit crisis fairly well, our portfolios were holding and the bonds in the accounts were doing their job of reducing the downside. Since then, not only have stocks been highly unpredictable, the bond and fixed income markets everywhere have not been helpful in protecting values in the short term. With the exception of municipal bonds, September was the worst month for bond prices that we have seen with investors fleeing all forms of fixed income investments except for bank accounts and Treasuries. When the buyers flee from any market, prices decline; and as we know, price declines are not always reflective of what something is actually worth, but nonetheless it makes the account statements look awful.

Our Thinking

Prior to the bailout, we made a decision to reduce exposure to some stock fund holdings by approximately 10% and eliminated most of the emerging market bonds and emerging currency exposure. Given what has happened over the last couple of weeks, this was a good decision in the short term. Our current thinking going forward keeps us concern about risk; however, recognizing that in order to add long-term value we need to be able to become more aggressive at some point by taking advantage of cheaper prices when we believe the opportunities are compelling. That can be difficult psychologically, since even at bargain levels any investment can exhibit additional short-term risk. Nevertheless, we still remain underweighted to equities and will be using the additional cash from this change to take advantage of opportunities.

Specifically we are looking for opportunities to grow the portfolios focusing on dividends and interest earnings (yield). We do believe this will be increasingly important as the credit concerns work their way through the system. If the market stays in an environment of flux, we will find it easier to bear if the holdings in the portfolios have high dividend and interest payments. At least your account is being paid to wait for recovery. One thing we need to remember is that when we have an asset that pays a dividend (stock) or interest (bonds), a temporary decline in prices means that the investment is worth less at sale, but still pays the same income.

For example, if you owned a Home Depot bond with a purchase price and maturity value of $100,000, that pays interest of 5.00%, you would receive $5,000 of interest in the next year.

Yield = 5.00% ($5,000/$100,000)

In the case of the current market environment, investors are afraid of bonds right now, therefore the market value of the Home Depot bond drops as it has to approximately $70,000. If we sell the bond, you not only lose $30,000, but you would lose the income of $5,000. Once the bond is sold, then you would take your money and put it somewhere safe, like your checking account. Here is a question: Could you take the $70,000 and earn $5,000 in interest over the next 12 months? The answer is no, because you would have to earn the following:

Yield = 7.14% ($5,000/$70,000)

Therefore, as long as the bond (or stock) isn't going to go out of business, we will receive the income each year, and in the case of the bond, a maturity value at some point of $100,000. Currently, there is nowhere to go right now to earn these yields. In fact, with the yield that can be earned on a bond like Home Depot, how long will it take until investors come running back to the markets? Not long.

The Election and Taxes

It seems hard to deny that taxes will most likely be increasing in the future. It doesn't really matter what party candidate gets elected at this point; the current government spending levels need to be supported by something. Specifically we may have a change in the tax treatment of dividends and long-term capital gains. Currently, these are taxed at a maximum of 15%. If this is increased, we will need to proactively address how taxable portfolios should be managed in both the short term (taking gains) and in the long term.

These economic conditions over the next year will certainly demand that we all have a combination of patience, common sense, and discipline. The principles of economics are at work even now, and the eventual outcomes are generally predictable, although not specifically foreseeable. What isn't always predictable is how we as human beings deal with times like these, and we can never underestimate the power of fear and emotion.

FAI Advisors, Inc.
Investment Policy Committee (10/10/08)

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