

Parsec Financial

Third Quarter 2008 Newsletter

Financial Advice and Planning

BONDS VERSUS BOND FUNDS



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Special Points of Interest

- Individual bonds or bond funds?
- The global commitment to stop the panic is the largest ever and it will succeed.
- The third quarter Parsec Prize is awarded to Literacy Council of Buncombe County.

Historically, news on the bond markets is relegated to the back pages of the Wall Street Journal and rarely captures the interest of investors as equity markets consistently do. However, due to the turmoil in the credit markets, discussions on bond investments have moved to the forefront. As we have mentioned in past newsletters, the long-term portion of your portfolio should be geared towards stocks. The bond component of your portfolio should be geared towards short to intermediate term to meet your cash flow requirements. Here we will discuss the major differences of investing in individual bonds versus bond mutual funds.

For many investors, bond mutual funds make sense primarily due to their convenience and instant diversification. For example, PIMCO Total Return fund is rated 5-stars by Morningstar, has \$75 billion in assets, and has over 15 thousand holdings. Therefore, with one purchase, an investor may assume there is safety in numbers. Along with the purchase of a mutual fund comes a professional manager backed by a strong research team that can make better decisions than the average individual investor. Parsec believes this is especially warranted in the realm of high-yield bonds and international bonds.

Without an investment advisory firm, like Parsec, on your side, bond funds can be trickier than bonds. First, the income is not "fixed" and there is no contractual obligation to return the investor's principal at some later maturity date. In addition, the risk-return profile is continually changing as fund managers constantly trade their positions. Next is

the issue of mutual funds passing along capital gains to the fund holders. Fund managers incur capital gains and losses throughout the year which are then passed along to fund holders usually at year end. Even if the fund distributes tax-advantaged income, the capital gains are still taxable.

If you and your Parsec advisor have determined that a portion of your total portfolio should be invested in individual bonds, we will utilize various techniques to help meet your investment goals and time frames. Buy-and-hold investors can manage interest rate risk by creating a "laddered" portfolio of bonds with different maturities, for example: one, three, five and ten years. A laddered portfolio has principal being returned at defined intervals. When one bond matures, you have the opportunity to reinvest the proceeds at the longer-term end of the ladder. If rates are rising, that maturing principal can be invested at higher rates. If rates are falling, your portfolio is still earning higher interest on the longer-term holdings. In addition to this, your Parsec advisor and traders will custom tailor your bonds for diversification in different sectors, types of issues, and credit quality ranges. Let's take municipal bonds for example. You and your advisor have determined that your portfolio should have \$1 million invested in individual, intermediate-term muni bonds. Our traders will build a laddered portfolio of approximately 10-15 bonds with maturities ranging from 5-15 years. In addition, we will diversify the holdings to include both General Obligation bonds and Revenue bonds while maintaining a high average credit quality (AA-/Aa3) for the portfolio. Lastly, we will differentiate among bond insurance companies as a further safety net.

So the debate of bonds versus bond funds continues. In accounts with a modest allocation to fixed income, bond funds are usually the best bet. In larger accounts, a combination of both will likely be recommended.

Dr. Jim Smith's Economic Commentary

THE CRASH DOES NOT MEAN ANOTHER DEPRESSION IS COMING



Dr. James F. Smith,
CHIEF ECONOMIST

The richest person in Italy is Silvio Berlusconi, who by no coincidence is also the Prime Minister or head of the government. The Financial Times (known as the FT or “The Big Pink” for the salmon-colored paper on which it is printed) quoted him in its October 11-12 edition as saying last week, “The stock markets are currently in the grip of panic and madness. If you have shares, absolutely don’t sell them.”

On Wednesday, October 8, I was attending the 50th Annual Meeting of the National Association for Business Economics (NABE) and had the opportunity to publicly ask Dr. Eddie Lazear, a professor who is on leave from Stanford University to serve as chair of the President’s Council of Economic Advisors, a question. I asked, “Given all the financial and economic turmoil you’ve just described so well, has any thought been given to having President Bush deliver a televised, prime-time speech that would be as good as his post-9/11 one to tell the American public that all possible steps were being taken around the globe to stop the crisis? And also to let people know that the best contribution they could make to improve the situation is to relax and continue buying the goods and services they always have?”

Dr. Lazear didn’t seem to think that would be very useful. The relatively wimpy talk that President Bush gave around noon EDT on Friday (October 10), while it had worthwhile content, had no impact whatsoever on calming market participants as the Dow Jones Industrial Average (DJIA) continued its most volatile trading day ever, with a trading range of 1,019 points before closing down a “mere” 128 points or 1.49 percent. For the week, both the DJIA and the S&P 500 lost 18.2 percent, their worst performances since 1933.

The financial crisis began on August 9, 2007. That was the day that the huge French bank BNP Paribas (one of the 10 largest in the world with assets in excess of \$1.3 trillion) told owners of shares in three of its mutual funds they could not redeem them “because we own bonds based on U.S. subprime mortgages that we can’t put a value on right now”. Since then, financial panic has spread around the world.

Nothing makes an investor more angry or scared than being unable to cash out his or her investment from a fund. This problem has recurred many times throughout history. A comprehensive

documentation that is also a most delightful and interesting book to read is *Manias, Panics, and Crashes: A History of Financial Crises* (5th Edition) by Charles P. Kindleberger and Robert Aliber. This wonderful book, which has always been a huge hit with my MBA students in the several second-year elective courses when I’ve used it, covers the history of financial panics around the world from Kipper-und-Wipperzeit of 1619-1622 and the Dutch tulip bulb episode in 1636-1637 through the Asian collapse in 1997, as well as the Russian default and the collapse of Long Term Capital Management in 1998 and the corporate scandals of 2001-2003 (Enron, Worldcom and so on).

The Wall Street Journal had a lead editorial on September 16 (“Surviving the Panic”) referring to the usefulness of this book in understanding the current situation. You’ll feel better if you get a copy of the book and peruse it carefully.

A primary lesson from the book is that the way to stop panics or reverse crashes is to have a lender of last resort supply whatever capital (liquidity) is needed to the financial markets to end fears of being unable to get your money out of the bank or investment fund. This is what the Federal Reserve System (the Fed) and central banks around the world failed to do in 1929, which was a major factor in turning what should have been the recession of 1929-1930 into the Great Depression of 1929-1933. They won’t make that mistake again, although they were rather slow in getting started.

The Fed Is On the Case

Fortunately for all of us, Fed Chairman Ben Bernanke made his sterling academic reputation partly from his studies of what caused the Great Depression of August 1929 to March 1933. He has been busily applying that knowledge.

The Fed has both flooded credit markets with liquidity and cut interest rates. They started that strategy on September 18, 2007 when they cut the target for the Fed Funds rate from 5.25 percent to 4.75 percent. The FOMC made six more cuts through April 30, 2008, when they dropped it to 2.0 percent.

At his October 9 luncheon speech to the NABE audience, Chairman Bernanke made it very clear that inflation was no longer a problem and economic growth was the top issue. The next morning the Fed announced that not only had the FOMC voted unanimously to cut the Fed Funds target to 1.50 percent, but that this action was coordinated with similar moves by the Bank of Canada, the European Central Bank, the Bank of England and the central banks of Denmark, Norway, Sweden and Switzerland. Other central banks including those in China, Hong Kong, Taiwan and the United Arab Emirates joined in the rate cutting effort too.

Additionally, the Fed and many of these other central banks have announced programs to buy commercial paper and to make tem-

porary loans to banks, essentially without limit. The global commitment to stop the panic is the largest ever and it will succeed.

The Economic Stabilization Act of 2008 Will Also Help

This legislation, which people (including President Bush on October 10) keep referring to as “the \$700 billion bailout,” includes hundreds of unrelated things in its 451 pages, such as the repeal of the \$0.39 excise tax on wooden arrows for children. The core is the Troubled Assets Relief Program or TARP. Also important is the temporary increase in deposit insurance to \$250,000 per account.

The potential investment of taxpayer dollars is over \$1.2 trillion, rather than \$700 billion. No one knows how much will be spent, but the final result to taxpayers is likely to be a profit.

The legislation gives unprecedented power to the Secretary of the Treasury. There can be no question that these efforts, with full international support and cooperation, will work to stop the panic.

The basic problem around the world is that banks will not lend to each other. That means credit markets are frozen. They need to be thawed out and opened up quickly. It should be noted that most of the problems involve large banks and large companies. All evidence through September shows that small business owners are having little trouble getting all the credit they need at reasonable rates.

The Economy Should Rebound

Another presentation at the NABE meeting was from Professor Robert Hall of Stanford, who has been the head of the Business Cycle Dating Committee (BCDC) of the National Bureau of Economic Research since its inception in 1978. While he made it very clear that the committee was unlikely to tell us when the peak occurred (measuring when a recession begins), he also left no doubt his personal opinion was that we are definitely in a recession now.

Based on the data for nonfarm payroll employment and industrial production, two of the four most important cyclical indicators, that peak would have been in December 2007. Since then, both have declined.

The cumulative decline in nonfarm payroll employment has been 760,000 jobs through September. While that is a lot of jobs, it is only 0.55 percent of the number that existed in December 2007.

Furthermore, only the September decline of 159,000 jobs from August was statistically significant. It takes a move of 104,000 up or down to meet that threshold. If we had good data on how many people were on strike at Boeing or laid off because of Hurricanes Gustav and Ike, it's highly likely that the September number would not have been statistically significant either. Still, there is no question that the number has been trending down for many months.

The unemployment rate remained at 6.1 percent in September. That was up dramatically from the 4.7 percent a year earlier.

There are huge differences among states and metropolitan areas. For the year ended in August, the unemployment rate rose in 47 states and the District of Columbia. Yet it fell in three states (Arkansas, Oklahoma and West Virginia). At 4.1 percent, West Virginia had its lowest unemployment rate since the start of the state data series in 1976.

In August, Michigan and Rhode Island had the highest unemployment rates in the U.S. at 8.9 and 8.5 percent, respectively. Six other states were above 7.0 percent.

The lowest unemployment rates were in South Dakota (3.3 percent), Nebraska (3.5 percent), North Dakota (3.6 percent) Utah (3.7 percent) and Wyoming (3.9 percent). North Carolina had a huge increase in its unemployment rate. We went from being right at the national average of 4.7 percent in August 2007 to 6.9 percent in August 2008, an increase of 2.2 percentage points.

On September 30, the Bureau of Labor Statistics (BLS) reported that unemployment rates in August were higher than a year earlier in 354 of the 369 metropolitan areas, lower in 13 and unchanged in two. That is definitely an indicator of widespread distress.

The range was from a low of 2.6 percent in Sioux Falls, SD to highs of 24.7 percent in El Centro, CA and 22.7 percent in its neighboring Yuma, AZ. The BLS notes that unemployment is always higher in those two areas in the summer “due to the effect of extreme heat on agricultural activity.” It's still usually well into double digits in the winter.

The Asheville metropolitan area consists of Buncombe, Haywood, Henderson and Madison Counties. Our unemployment rate rose from 3.4 percent in August 2007 to 5.5 percent in August 2008. Only in the Triangle—the Durham and Raleigh-Cary areas—were rates lower in the state at 5.4 percent each.

The U.S. economy needs a turnaround in residential construction activity to get moving again. That could happen very soon as the August data were at their lowest levels since January 1991, near the end of the July 1990 to March 1991 recession.

I have cut my forecasts for real GDP growth for the U.S. to 1.7 percent for 2008 and 2.6 percent for 2009. The International Monetary Fund has lowered their estimates to 1.5 percent for this year and 0.5 percent in 2009. The difference comes from the timing of the rebound. Here's hoping I'm right.

A record Christmas shopping season should help make that happen. So get out there and shop: it's the American way.

Stock Market Outlook



Bart Boyer, CFP®
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As of this writing, October 15, the S&P 500 is 947, (including the +11.5% Monday!) a negative return of about 35% for the year. It has been brutal; fear is pervasive. Over the last 70 years, the worst year for the S&P 500 prior to 2008 was 1974, -26.5%. You have to go all the way back to 1937 to get as bad as 2008 so far, also -35%.

Is the current decline justified? Are things really that bad? In 1937 there was a worldwide depression, now there is a worldwide slow-down that could turn into a recession. Then we had World War brewing in Europe and the Pacific. Now we have the war in Iraq coming towards a successful conclusion. True, today we have a credit squeeze but central banks and governments are taking unprecedented and coordinated actions to strengthen lenders and improve liquidity in the system.

Average bear market price declines tend to be about 30-35% and last about 1 year from the top to the bottom. We are already at these levels based on current stock prices. Stocks are now attractively valued relative to their long-term average, as well as relative to current low levels of inflation and interest rates.

People are trend followers. In the late 1990's it was "irrational exuberance". Then came housing – "straight up forever!", then the com-

modity bubble and now irrational pessimism. Just because others are selling assets at fire sale prices doesn't mean that we should. If you just stay in place you are assured of getting the recovery that always comes. If you get out, you are very likely to miss the recovery. That mistake could devastate your financial future. Don't do it!

Energy prices are way down. Oil didn't go to \$200 a barrel as predicted, it is now \$74.54. Unleaded gas at the wholesale level is \$1.78 per gallon, down \$1.76 from the peak. That should begin showing up at the pump in time for the holiday shopping season. Won't it be nice to have an extra \$300 billion or so spent here in the U.S. over the year ahead vs. going overseas? Commodity prices are also down significantly from their highs. This has reduced concerns about future inflation and will help both consumers and businesses.

Contrarian indicators are also pointing to better times ahead. Investor sentiment is at the lowest level in 14 years. Low levels of sentiment are often followed by market advances.

The "fear index", more formally known as the CBOE Volatility Index, is at an all-time high since its inception in 1990. This demonstrates that panic is ruling the day, and a high fear index is another indicator that historically has preceded market advances.

While we agree that our economy is not without problems, we are not in the camp that believes we are in uncharted territory or retracing the steps that led to the Great Depression. We do believe that better times are ahead for patient investors who do not succumb to the current environment of fear and panic.

Parsec Prize

The third quarter Parsec Prize recipient is the Literacy Council of Buncombe County. The mission of the Literacy Council is to improve adult basic education and English language skills through one-on-one and small group instruction provided by trained volunteers. The council works to help each individual reach their full potential as individuals, parents, workers, and citizens and believes that when adults increase their basic education and English language skills, they improve their chances for employment and therefore, financial success.

The Parsec Prize was created by Parsec Financial as a means of sup-

porting those organizations that work to improve education and prospects for economic development in our region. Currently, Parsec donates 2% of revenues to non-profit groups, a portion of which funds the Parsec Prize. The quarterly Parsec Prize this year is \$17,000.

Grants are made to non-profit organizations that are certified tax-exempt under section 501(c) (3) of the U.S. Internal Revenue Service code. For specifics on how to apply for the next Parsec Prize, please visit www.parsecfinancial.com.

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