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...a financial engineering approach

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**Our Two Great Enemies in the fall of 2008, and
What may Save Us All!**

Normally I only write a “situation letter,” as we call these pieces, every few years. Usually it’s instigated by a large change in our outlook or portfolios or some other outside calamity or opportunity, such as that to which Ricky Ricardo would say, “Lucy, you got some s’plaining to do!”

Recently, I have been writing them nearly every week. And now here I am at it again, because some clarity is emerging as to where we are and what is going on, I think.

I believe we have two enemies. The first one is, of course, the news media. While the situation is serious (perhaps even grave), the amount of additional fear they (the media) are propagating is beyond definition. We have heard of some otherwise level-headed people who have started to watch the TV all day long as a result of this fear. There is only one thing that can come from that type of fear and that’s panic. They are making a bad situation a lot worse.

On to our second enemy. This mess started over a year ago in the mortgage markets with concerns over profitability (survivability wasn’t in question until months later). The crisis has morphed as it has spread across lots of different countries (but just a few industries); now it seems it is going to impact us all, one way or another.

The one thing that makes it seem especially scary is that the stock market seems to be refusing to find a bottom, although I hope that by saying that, it will prove me wrong!

Back in the days following 9/11 we knew what the problem was, and while scary, it seemed we could handle it. That problem, other than the tragic loss of life, was that terrorism had been brought home to us. That is something we had not seen before.

But in a simple sense, 9/11 was one event. Imagine what the stock markets would have done if a week after the World Trade Center Towers went down, we lost the Golden Gate Bridge, then the next week it was the Sears Tower, and so on and so on, and each time after the event, the government declared all was safe and the attacks were over, only to be followed by another attack out of the blue?

I believe this is comparable to what is happening now, as huge financial institutions, which only days before had been pronounced likely to survive by our government, then failed, and in turn more sudden, significant and catastrophic calamities are then feared by the markets. The newscasters, who are certainly experiencing their 15 minutes of fame, then perpetuate the fear. This fear is expressed by the markets as they freeze up and the credit markets, banks, and companies won't loan money to each other because they don't know who will still be there tomorrow. This is the second enemy; the big boys are not playing with each other.

And who can blame them? We were told Lehman Brothers was sound, Washington Mutual had enough resources to see it through, and were led to believe that Wachovia was strong enough to help Morgan Stanley. Either people didn't know (and these are people who should know) or they are lying to us. Strong words, yes, but from my desk, I believe, accurate. This has caused a crisis of confidence, as well it should. "Fool me once, shame on you; fool me twice, shame on me," as the saying goes.

My point and I think it's an important one, is the stock market is not going down because of problems with stock values being too high. The stock market is reflecting the troubles in the debt market. We think this is why it can sell off like it can. If it was about valuation (prices are too high) then any one of the many massive sell offs should have given us a bottom. (This is good news, as I will explain.)

Instead, the stock market is fearing “another terrorist attack,” to put the “9/11” terminology into it, only for us this new terrorist attack is the loss of liquidity and the loss of use of the debt markets needed by our institutions, governments and industrial companies to operate.

This fear and the unknowingness about it in the credit markets is the main problem. Usually the stock markets operate and find their own levels; these days they are just the tail on a dog that keeps getting hit by car, then another, and another and so forth.

There are a lot of good news stories out there that we may hopefully look back on and say, some months from now, were a turning point:

- 1) Warren Buffett, through Berkshire Hathaway and Wells Fargo, made three large equity investments in financials in the past couple of weeks.
- 2) One of these, the Wachovia deal, sparked a heated confrontation over the takeover of a bank. That is the first we have seen of that type of action. Until recently, potential buyers of banks would wait until they could get them for almost nothing from a bankruptcy judge or the FDIC. A sea-change? Maybe.
- 3) There are real earnings and/or sales growth from some of our largest companies, such as IBM, Johnson & Johnson, Procter and Gamble, and McDonald's, to name a few.
- 4) The big one: Our government (Treasury and Federal Reserve) as well as governments around the world are on the case. No one “likes” the steps they are taking, but they are acting to solve the problem and get the machinery working again, get that dog out of traffic and on his way to the Vet. This is the largest, most well-financed economic rescue program in the history of the world and it's ongoing. I trust in them to throw enough money at the problem to get the system restarted. We expect a hangover from this rescue, but success always carries a price tag. (For more on that, look at our prior situation letter, titled “What to do now?”)

Conclusion

We know what the enemy is, and ALL the resources of the western world (or more) are being focused on getting this stubborn freeze to thaw. Once it does, a lot of the fear will go away, sure we will still have a recession to deal with, but we believe the stock market is worried about a lot more than that now. To only worry about a recession would be nice, very nice indeed.

A Special Compliment and Thanks to You

As our valued friends and clients, we would like to thank you. We did not, of course, cause this crisis that the world is in, but it has never the less changed the way we are acting and our outlook for the next few years. Without exception, each and every one of you has been polite and courteous to us, even as this mess has reduced all of our net worths. We are proud of our clients and how you have reacted. We have heard stories from others in this business that confirm our confidence that we have a most special group of people we work for. Thank you!

A question that comes up a lot, and it's a good one, is this: Why not just sell everything and sit on the sidelines until the storm clears?

Well, we wish we had a crystal ball, as do the 100,000 or so employees of Bear Stearns and Lehman Brothers, and the many tens of thousands who have defaulted or will default on their mortgages, lost their jobs, or are otherwise suffering due to this mess.

If we had a crystal ball we would be on the sidelines, but since we don't and because we don't want to miss the likely increase in the values of the stocks once this cloud of fear passes over us and the sun comes back out, we feel that we need to stay invested to be sure we are around for that future sunny day. I wish I could tell you when it will start, but that date is impossible to know. In the meantime, we are acting in what we think is a logical and prudent manner as dedicated custodians and guardians of your money.

We are ever mindful of our responsibility to you and your family, both to assist you preserve your capital and to potentially make it grow at a rate that is commensurate with the risk we take. During periods of vast disturbances like this, the prices of all assets (stocks, bonds, real estate, oil, cars, art etc.) might make us look, temporarily, like fumbling idiots, but we are always

looking ahead to what we anticipate happening once the clouds clear, the sea quiets down and the beautiful sun returns. Although it may not look like it, this is when we do our most efficient work.

Please remember: This, too, shall pass.

Thanks for your continued trust and confidence.

Sincerely,

Charlie Stoll

PS: If you didn't get our letter's called "The Perfect Storm" or the "What do We Do Now?" please give us a call!