Investment Watch

4th Quarter, 2007

The Year of the Roller Coaster

In China it's the ***Year of the Pig***, but here at home with this year's wild stock market ride, 2007 may come to be known as the ***"Year of the Roller Coaster!"*** Our youthful feelings of elation and exhilaration when ascending the Coaster's initial steep climb have been rudely transformed into anxiety and uncertainty by this year's rattling stock market ride.

The laws of physics require that your Roller Coaster drops you off at about the same level you boarded. Although the stock and bond markets have no laws affecting their operation, they have on average left you off about 10% and 6% higher each year, respectively. Even with this year's volatility, most stock and bond indexes ended the year with mid-single digit returns. So let's put all this turbulence and chaos into perspective and recapture our youthful calm composure as we start up the first *lifthill* of the New Year.

2007 started with *March Madness* when the DJIA plunged 416 points due to a 9% blip in *Shanghai markets*. Soon to be forgotten, the market began its 2nd quarter meteoric rise. But those gains vanished into thin air when our Independence Day party was crashed by the *summer's subprime mortgage meltdown*. Because we mistakenly thought that the credit crisis was short-lived, the 4th quarter's momentum thrust us to some all-time record levels. But our Coaster car hit the crest and careened down the next hill wiping out our gains with a December market correction. A *"double-dip camelback corkscrew"* year.

Whew! Pandemonium like this should only be permitted at adventure parks. Like the tourists at those theme parks, the pundits have that herd instinct. They tend to project the past as continuing into the future. When 2007 began, most talking heads declared that this market calmness was never-ending.

Since the markets began their ascent in early 2003, following the depths of the tech-bubble debacle, the upward rise had been steady and unwavering. Pundits proclaimed that the world had entered a *new era* of low risk and low volatility. They claimed our Coaster now came equipped with new and improved global shock absorbers to cushion our ride on the way to prosperity. Little did they know of the thrills and chills that lay ahead.

Last year the bad news seemed unrelenting. Maybe easier to understand why the volatility returned to the stock market. We battled a credit crisis precipitated by an overdue deflation of the housing bubble that had been forming for ten years. Not to mention a 60% rise in oil prices almost peaking at $100 a barrel and a precipitous decline in our dollar.

Historically **market corrections**, a 10% decline from a peak, occur about every 12 months. Because we hadn't suffered through a correction since the start of 2003, we were shaken by the 78 days of triple digit gains and losses in the Dow Jones Industrial Average. Over 30% of the trading days had triple digit swings and our first market correction in over four years—*Market Mayhem*!

Roller Coasters look scary—hundreds of feet in the air with vertical drops, loops and curves that make us feel that we are in danger. But good roller Coaster design emphasizes safety, fixed lapbars, harnesses, restraints and guide wheels to keep the car securely on the rails and us in our seats. Because market corrections are inevitable, we need to develop our own safety mechanisms to shield us from fear and keep us on track to reach our investment goals.

The pundits may be right that globalization will temper risk, but last year's motion sickness causing volatility proves that short term violent swings can't be eliminated. Wall Street's innovation in developing securities packaged as Collateralized Mortgage Obligations (CMO) and Structured Investment Vehicles (SIV), created a complex and interconnected financial system that when stressed by the housing downturn exposed unforeseen cracks in our economy.

Just like the ever-faster, ever-more-towering thrill rides, these derivative securities along with hedge funds and electronic trading may all be contributing to the velocity of our world and the volatility in our markets. However, the fear of the unknown triggers our biggest reactions. Uncertainty breeds fear. These new financial derivatives are so complex that even the rating agencies didn't understand their risks and the financiers who sold them have suffered the worst losses. The subprime crisis claimed Merrill Lynch's CEO and Citigroup, the largest company in the world, agreed to a cash infusion of $7.5 billion by Abu Dhabi, United Arab Emirates, now its largest shareholder at 4.9%.

Although the housing downturn and resultant credit crisis has dampened our growth, it may only be short lived. In the 2007 annual report of the Bank for International Settlements, the BIS says, *"… risks to financial stability appear to lie in the medium term… financial systems are well positioned to cope with the likely near term sources of strain."*

There may be some speed bumps in the near term, delivering those queasy *airtime* feelings, but strong global growth has added support to our already sturdy economy marked by low inflation, solid corporate profits, enhanced productivity and unstoppable consumers.

When we enter the *loading platform*, we are worried but excited. Investing bestows these same feelings. Let's take a long term point of view to calm our fears to help us absorb the jolts and shocks of these inevitable market swings and not let this rickety wooden behemoth of a stock market shake us to the core.

Long term investing gives you time to ride out the unavoidable and unpredictable short term ups and downs of the market. Diversification strives to smooth out risk to make the ride more comfortable.

Strap on your *shoulder harness* and lock down your *lapbars*, the all clear *thumbs-up* means we're ready to go on the new and improved 2008 model ***Roller Coaster***.

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4940 Washington Blvd.
St. Louis, MO 63108
(314) 367-6555