

September 29, 2008

Dear Valued Investor:

At the risk of offering too many communications, I want to keep you informed during these very turbulent weeks. Last Thursday night, Washington Mutual failed. Despite this being, by far, the largest U.S. bank failure, JPMorgan Chase took over their operations, assets and deposits immediately and with surprising smoothness. Depositors and customers should be fine. However, Washington Mutual equity holders were wiped out, and debt holders will likely get little return of their investment. Today, the FDIC announced that Citigroup was immediately taking over the commercial and investment banking operations of Wachovia in a complex transaction. The FDIC, our federal bank deposit insurer, did not lose money in the Washington Mutual transaction, and may not lose money in the Wachovia transaction. I think the FDIC has been doing a great job of handling these momentous events smoothly. Those little placards on bank counters really do have a great federal agency behind them!

On Sunday, Congressional leaders announced that they had finally reached agreement on a rescue package for the financial firms experiencing difficulty. While many details of what is now called the “Emergency Economic Stabilization Act” (EESA) remain to be resolved, this 109 page agreement likely means that a gradual return to normal functioning of credit markets is possible. While the \$700 billion sum that will be authorized is substantial, it is important to note that this is not an expenditure. The EESA funds will be used to purchase or insure sub prime mortgage debt and other low quality debt that, along with high leverage, has led to the failures and shotgun mergers we have seen to date. We taxpayers may or may not lose money with this program. The outcome will depend on the price we pay up front, the future course of the economy and home prices, and many other factors. This government program in combination with other actions already taken is intended to allow these troubled financial institutions to delever their balance sheets without the serious threat of bankruptcy over their heads.

The first vote on this Act in the House today failed, but House leadership on both sides have said that the Act will be “reconsidered” on Wednesday or Thursday. Between now and then, I expect that there will be some modifications to the bill and some arm twisting and that the Act will then be passed by the House. The Senate vote is scheduled to follow. With only one third of Senators up for election this year and noses easier to count, I think the Senate will vote in the affirmative, and so I expect passage of this Act.

It is safe to say that the market was very disappointed in the House vote, with the Dow, for example, falling about 578 points after the failed vote, adding to the 200 point loss earlier in the day. If there is no additional negative news tomorrow or Wednesday, the markets may remain at about these levels and allow Congress some breathing room to debate, amend and approve this legislation. Possible negative news to send the markets down further may come from Europe and the UK, or from indications that the EESA legislation will

not be passed this week. There is some positive news; the Fed has announced it will pump in an additional \$630 billion into the global financial system.

Now I certainly understand the concern and anger many of you have expressed over this program. If the Treasury pays too much for the assets it buys, the effort would become a Wall Street bailout and leave taxpayers stuck with the bill. However, I do see a bipartisan consensus that such a misuse of the funds is not going to be tolerated. On the other hand, the prices paid must be high enough to reduce failure risk by strengthening the current weak link in our system, high enough to rescue the institutions in crisis.

Are these further actions necessary? I can argue both sides. On the “yes” side, I would say that while these deeply troubled financial institutions are few, they provide a huge amount of lending, securities issuance, trading, clearing, custody, and other functions. They are analogous to the oil for your car’s engine – not a big part, but absolutely essential for the engine’s operation. This analogy is why folks keep talking about credit markets “seizing up”. We are running our economic engine while it is low on oil. Now we could just park the car, let these Wall Street firms succeed or fail on their own and then build new firms to provide the oil. But that course is risky and we are not sure what would happen. I doubt that it would lead to the Great Depression II, but it might turn what looks to be a developing modest recession into a bigger one. So to prevent a deeper recession, the rescue is probably a good idea.

On the “no” side, I would say that we may be able to whistle past the graveyard and avoid serious consequences. Maybe the many other good banks will continue to pick up the slack on lending and acquire the needed pieces of failed banks, as JPMorgan has done, and we can all move on. And the program does have problems of its own. The rescue could turn into a bailout, costing us taxpayers money and rewarding bad behavior and bad decision making at a few large financial institutions. It could turn into a “let’s bail out everybody” program, rewarding folks for their bad decisions on home purchases and all sorts of other people—spec. homebuilders, home “flipping” speculators and the like at the expense of the vast majority of homeowners who pay their mortgages on time. In my experience, real estate bailouts are always unavoidably inequitable and ugly. And the rescue could expand to other lenders and borrowers; lobbyists are swarming Washington.

Weighing both sides, I have to say that while my heart says no, my head says yes to the Emergency Economic Stabilization Act. I think that the benefits will likely outweigh the costs. I am glad there has been a vigorous debate over the program and that the legislation now incorporates a number of important safeguards. They will likely be needed as this program unfolds over the weeks and months ahead. We are not out of the woods. Other banks could fail, but let me hasten to add that I think the vast majority of banks are sound, with solid balance sheets and good business models and prospects.

Unlike some of these big troubled financial institution prognosticators who assert that without the EESA Armageddon will follow, I can say, without bias, that I think the package is on balance the right way to go and we will over time recover from this ordeal.

These truly are troubled times. Absolutely stunning mistakes and very bad business and investment decisions have been made by some Wall Street firms. The damage has been large. I am not happy, and I am sure that you are not happy to now be a part of this rescue package. Nevertheless, I do take comfort from the fact that, while some financial firms have levered up on very risky investments, most non-financial companies have not. Non-financial U.S. corporations have, in aggregate, de-levered enormously over the last 12 years, stripping \$2 trillion of net liabilities off their balance sheets. U.S. non-financial corporations are now, for the first time in history, net lenders, not borrowers. And, unlike financial corporations, non-financial corporations have also reduced their net equity—by about \$2 trillion dollars over the last four years. The combination represents, in my opinion, a huge deleveraging that surpasses the direction Wall Street took. So, while we deal with this problem of overly levered, bad investments at a few, but important Wall Street firms, we need to maintain a sense of proportion. The vast majority of American workers and companies have, in my opinion, conducted themselves well. And I believe that these companies and their stock and bond prices are, generally speaking, fairly or under valued. I do think that the rescue program will work to quell this financial market crisis and we can return over time to evaluating the substantial fundamental economic value in the market. In the midst of this financial crisis I think it is important to maintain perspective. Panicky moves away from well balanced investment portfolios at times like this most often in my experience lead to locking in losses and missing the ensuing recovery.

As always, but especially now, please call your financial advisor with any questions or concerns.

Sincerely,



Lincoln Anderson  
Managing Director, Chief Investment Officer

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