ESTATE COUNSELORS, LLC

INVESTMENT ADVISORS

SPECIAL REPORT

TO: Friends of Estate Counselors, LLC

FROM: Andrew Willms

DATE: November 3, 2011

RE: "Aftershock: Protect Yourself and Profit in the Next Global Financial Meltdown"

Recently several clients have expressed concerns to me about the long term direction of the U.S. economy after having read "Aftershock"[1], by David Wiedemer, Robert A. Wiedemer, and Cindy Spitzer. This encouraged me to read the book. After having done so, I came to the realization that many of the authors' warnings and advice were quite similar to those being expressed by certain commentators in the national media. This memorandum reflects my thoughts regarding these predictions and recommendations.

I. Overview

"Aftershock" is a follow up to a prior book by David and Robert Wiedemer that discusses the authors' views on the state of the U.S. economy.[2] The book has received a lot of attention because in their first publication, the authors correctly foresaw the collapse of the residential real estate market that in turn led to the 2008 economic crisis. The authors come from diverse backgrounds, but only David has a degree in economics.[3] And while the book contains asides on global warming and gun control that seem to suggest that the authors are politically aligned with the left, they advise their readers to ignore their personal political biases and to instead focus on the fundamentals of America's fiscal situation as they see it.[4]

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[1] *Aftershock*: Protect Yourself and Profit in the Next Global Financial Meltdown.

[2] Brothers Robert and David Wiedemer first book was "America's Bubble Economy", which was originally published in October, 2006.

[3] David Wiedemer earned a PH.D. in economics from The University of Wisconsin-Madison. Robert Wiedemer has an MBA in marketing from the same university. Cindy Spitzer is the president of Aftershock Consultants, which provides financial advice to individuals and companies based on the book. She co-authored "Sex for Grownups" with Dr. Doree Lynn.

[4] Somewhat harder to ignore are the repeated plugs for the authors' website, newsletter and financial advisory services, which could cause some to question the motivation for the authors' conclusions.

The premise of the book is that for the last several decades the U.S. economy has been built on unsustainable bubbles: namely, the real estate bubble, the stock market bubble, the private debt bubble, the discretionary spending bubble, the dollar bubble and the government debt bubble. The authors believe that these "six co-linked bubbles have been growing bigger and bigger, each working to lift the others, all booming and supporting the U.S. economy". In their view these bubbles are not sustainable and eventually will burst, and when they do, the U.S. and the world economies are destined to endure severe aftershocks that will devastate portfolios of investors who are caught unprepared.

> *"The first four of these bubbles began to burst in the Bubblequake that rocked the U.S. and world economies in late 2008 and 2009. Next, while most people think the worst is over, the coming Aftershock will bring down all six bubbles in the next two to four years," totally changing the economic face of the U.S. and of the world.*
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> *Houses are still over-priced, and values must fall dramatically. The stock market is over-priced, fueled by money created by other bubbles and by the Fed. Assuming a constantly-growing economy, consumers and corporations took out loans they thought would be covered by ever-rising asset prices, which have since fallen, creating a private debt bubble.*
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> *Private spending accounts for 70% of the nation's economy, but the collapse of the private debt bubble further restricts money available for non-discretionary purchases. Meanwhile, the U.S. dollar rose in apparent value because of 'rising demand for dollars to make investments in our bubbles'. Now the falling bubbles will eventually create falling-value dollars."*

Aftershock argues that the 2008 - 2009 economic upheaval was just a mild precursor of what is yet to come. In their view "the whopping U.S. government debt bubble is currently the biggest, baddest, scariest bubble of all." The authors predict this bubble will burst sometime between 2013 and 2015, and when it does, the U.S. and world economies will have to endure severe aftershocks (hence the name) for several years thereafter.

More specifically the authors expect foreign investors to become disillusioned with investing in the U.S. government debt. This, in turn, will lead to a lessening of demand for U.S. dollars. This decrease in demand, combined with a dramatic increase in supply due to attempts to stimulate the economy via quantitative easing, will trigger the bursting of the dollar bubble. When that happens, the value of the U.S. dollar will plummet, resulting in double digit rates of inflation.

While Aftershock predicts that the U.S. and world economies will suffer severe trauma, the authors stay away from the doomsday scenarios that some other market commentators predict. In the authors' view the U.S. will not descend into chaos, and in fact they conclude the dollar will retain its status as an important reserve currency. "Life will be much better than in the Great Depression, but it will feel much worse," because Americans unrealistic expectations will be brought crashing back to reality.

II. **Discussion**

1. What's ahead?

Part I of Aftershock discusses why the authors believe that the U.S. economy is destined to suffer an extended and severe crisis. As mentioned above, the basic premise is that uncontrolled spending by the federal government will lead to the bursting of the government debt and U.S dollar bubbles. In support of this theory the authors assert:

- The U.S. debt (which currently stands at $14 trillion) is seven times what the government collects in taxes. Our nation's leaders lack the courage to raise taxes, which in their view is needed if the deficit is to be brought under control.

- From 2007 to 2010, U.S. gross domestic product ("GDP") increased by $600 billion (from $14.0 trillion in 2006 to $14.6 trillion in 2010). During that same time frame, government borrowing and spending increased by $1.2 trillion (from $163 billion to $1.363 trillion), almost double the increase in GDP.

- More than 40% of what the federal government spends is paid for with borrowed money.

- Since 2008, the Federal Reserve has dramatically increased the money supply in an effort to stimulate the economy through programs referred to as quantitative easing or "QE". More specifically, QE1 increased the money supply from $800 billion to $2.4 trillion, a 200% increase. QE2 added another $600 billion.

According to Aftershock "the one thing that we can absolutely count on to happen when the money supply is massively increased in an economy that is not growing equally quickly: f*uture inflation*". (Emphasis theirs). In fact according to the authors, inflation rates will reach as high as 10%.

Aftershock warns that once inflation takes hold "investors will become noticeably more skittish about the dollar and gold will go higher. At this point real problems start to happen." Inflation will drive interest rates higher, which will force the federal government to pay higher rates of interest. This, in turn will force the government to print more money, increasing the supply of dollars, which in turn will lead to a further decline in the value of the dollar and in turn higher interest rates. Eventually, as more and more dollars are in circulation, the dollar bubble will burst, and the value of the dollar will free fall. The authors conclude “When inflation and interest rates rise, asset values across the board will fall, and the dollar and the debt bubbles will finally pop”, which is most likely to happen sometime between 2013 and 2015.

2. What to do.

Part II of Aftershock offers advice on how to protect your investments from the coming “Bubblequake”, and in fact even profit from it. While a detailed critique of all of the recommendations found in Aftershock would undoubtedly try your patience, taking a closer look at a few of the authors’ suggestions is warranted.

Recommendation 1: *Dump all your stocks, stay away from real estate and stay away from long-term bonds until after the Dollar bubble bursts.*

This first recommendation is a case book example of an investment strategy known as market timing (sometimes euphemistically referred to as “tactical asset allocation”). In fact, Aftershock goes so far as to declare that “timing is everything”.

Market timing can be defined as any investment strategy that recommends portfolio asset allocations be changed in response to external market or economic conditions. The fallacy that market timing will produce better results is well documented. For example, a 2002 study by Standard and Poors revealed that a hypothetical $10,000 investment in large-cap U.S. stocks (represented by the S&P 500 index) over the 10 years ending June 30, 2002 would have earned 14.43% on an annualized basis or $29,509 as a result of remaining fully invested. Missing just the 10 best market days - an average of one day per year - would have cut total earnings by $10,336, and the annualized return by 4.7%.

The reality is that while it is tempting to believe that really smart, hardworking, well educated and insightful investment advisors can predict bear markets and, therefore, can advise their clients to sell stocks before the bear markets arrive, there is virtually no evidence of the persistent ability to do so. Rather there is a large body of academic evidence suggesting that trying to time markets is very likely to lead to abysmal results. Consider the following:

- In 2006, the University of Pennsylvania released the results of a twenty year study during which 284 “experts” were asked to assess the probability of an event occurring in their field. The study reviewed 82,361 expert predictions during that period. The study found that the better known and more frequently quoted the expert is, the less reliable their prediction about the future is likely to be. In fact the “experts” performed worse than if the predictions had been made at random, and no better than individuals with no expertise in the field.

- In December 2007, Business Week published an article that revealed the opinions of seven stock market "experts" on their predictions for the stock market in 2008. Every analyst predicted higher stock prices, and on average they predicted 12.61% growth in the S&P 500. In fact, the S&P 500 fell 38% in 2008.

- An article that appeared in the spring 2010 copy of McKinsey Quarterly compared the accuracy of analysts' forecasts of S&P 500 companies to their actual performance. The research showed that analysts were "typically overoptimistic, slow to revise their forecasts to reflect new economic conditions, and prone to making increasingly inaccurate forecasts when economic growth declined".

- Vanguard conducted a study of the performance of different defensive investment strategies that adjusted asset allocations in response to macroeconomic market indicators to see if they produced higher risk-adjusted rates of returns. Vanguard reached the conclusion that "Even the most reliable indicators have low predictive power when used to execute real-time strategies. Investors seeking to mitigate equity market risks are better served with a strategic allocation to fixed income investments." A similar study on the performance of 100 pension plans that engaged in tactical asset allocation found that not one single plan benefited from their efforts.

- Bill Miller was perhaps the most highly regarded investment advisor from 1990 until 2005 as his Leg Mason Fund outperformed the S&P 500 for 15 years. Then, the fund underperformed that same index by 10% in 2006, 12% in 2007, and 18% in 2008. In fact, his fund lost over one-half of its remaining value (55% to be precise) in 2008.

- The Tiger Fund was a hedge fund formed in 1980 by the highly-respected Julian Robertson with $10 million in capital. The fund then grew by an average of 30% a year for the next 18 years, reaching $22 billion under management by 1998. However, by the time it was forced to close in 2000, investors had lost $10 billion.

I could go on and on, but hopefully the point has been made. That is, when it comes to the predictive abilities of market gurus, past performance is **not** indicative of future results. That warning seems to be particularly apropos in the present circumstances in light of David and Robert Weidemers prior track record.[5]

[5] Robert and David Wiedemer run the Business Valuation Center, which provides financial valuation services to the Small Business Administration. Before consulting for the government, Robert and David were in charge of Pricesaroundtheworld.com, a dotcom-era bust. Currently David serves on the board of Proxim

Of course, the Weidemers are not the first persons who parlayed a bold prediction that came true into large personal wealth. Market forecasters have a strong incentive to make extreme predictions, especially if they have books to sell. Such predictions attract publicity, name recognition and sell books. Unfortunately, far too often only the forecasters and publishers profit from these bold predictions. As the following examples make clear, even the most scholarly of market forecasters can make predictions that cost their followers a fortune.

- Irving Fisher was a noted 20th century economist that Milton Friedman called "the greatest economist the United States has ever produced". Many of his contributions to economics, such as the Fisher equation, the Fisher hypothesis and the Fisher separation theorem are cited by economists to this day. However, notwithstanding his incredible intellect, Mr. Fisher made one of the most infamous predictions of all time. Three days before the Wall Street Crash of 1929, he claimed that, "stocks have reached what looks like a permanently high plateau".

- "Dow 36,000: The New Strategy for Profiting from the Coming Rise in the Stock Market" by James Glassman and Kevin Hassett was published in 2000 and boldly predicted the Dow would soar to 36,000 by 2010. As it turns out, that prediction proved to be more than a little too optimistic.

- Robert Metcalfe is a General Partner at Polaris Venture Partners, a venture capital firm that specializes in early investments in technology companies. Mr. Metcalfe founded 3Com digital electronics company and holds a PH.D. from Harvard. Yet, despite his impressive resume, in 1995 Robert Metcalfe predicted that "the internet will soon go spectacularly supernova and in 1996 catastrophically collapse".

- Goldman Sachs analyst Abby Joseph Cohen earned economics degrees from Cornell University and George Washington University, and is a Chartered Financial Analyst (CFA). Cohen began her career as an economist in 1973 at the Federal Reserve Board in Washington, and from 1983 until 1988 served as the vice president in charge of investment strategy at Drexel Burnham Lambert. Ms. Cohen gained fame in the 1990s for having correctly predicted the bull that occurred

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Wireless, a bulletin board-traded communications firm that in 2004 has suffered as a result of it acquisition what remained of Ricochet, a company founded by Microsoft co-founder Paul Allen in a failed attempted effort to bring Wi-Fi to cities in the 1990s. Also in the 1990s, David and Robert co-founded and ran Imark Technologies, which went bankrupt in 1998 when a business plan to get publishers to sell CD-Rom data over the internet failed.

> early in the decade. But her ability as a forecaster was brought into serious question shortly thereafter as a result of her prediction in 2001 that "The time to be nervous was a year ago. The S&P then was overvalued, it's now undervalued." In actuality stock prices continued to fall for another 18 months.

Perhaps legendary economist Peter Bernstein said it best when he provided this insight:[6]

> "Even the most brilliant of mathematical geniuses will never be able to tell us what the future holds. In the end, what matters is the quality of our decisions in the face of uncertainty."

Recommendation 2: *Buy Gold, and Lots of It! The coming gold bubble could easily last 10 or more years, and at its height, gold prices could become truly stratospheric - so high, in fact, we won't even mention our best guess for fear of losing credibility.*

According to Aftershock, one of the best ways to combat the evils of inflation is to invest in gold because “gold is not inflation or interest rate dependent unlike stocks, bonds and real estate, so gold is one of the few remaining investments that will not be brought down by inflation and rising interest rates”. This viewpoint leads the authors to proclaim that “The rising gold bubble is your very best bet for profits during Bubblequake and Aftershock”. Now that’s what I call a prediction!

It is true that the price of gold has been hitting record levels lately for many of the same reasons expressed in Aftershock; namely, the rapid increase in governmental debt, uncertainty surrounding world currencies, and central banks around the world printing money to support their governmental spending and over-leveraged banks. But a closer examination reveals that the price of gold has not always kept pace with the rate of inflation.

In his highly acclaimed book, "The Only Guide You'll Ever Need for the Right Financial Plan", Larry Swedroe documents the fact that gold has gone through very long periods where it lost value in real terms. For example, gold traded at $850 per ounce in 1980, then traded at around $900 per ounce at the end of 2009 -- 29 years later. During this time, inflation averaged 3.55 percent per year.

Perhaps of even greater concern is the fact that gold is exhibiting a bubble like rise in price that is very similar to other bubbles the authors warn about. The price of gold has risen by a factor more than 11 since 1977. As the following chart indicates this is much greater than the price of other goods, notwithstanding gold’s virtual price freeze from 1980 to 2009.

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[6] Peter L. Bernstein (January 22, 1919 – June 5, 2009) was an American professor, economist, and investment manager who is best known for the development of the efficient-market hypothesis.

	1977	2011	Factor
Cost of a new home:	$54,200	$205,000	3.78
Median Household Income:	$13,572	$55,000	4.05
Cost of a first-class stamp:	$0.13	$0.44	3.38
Cost of a gallon of regular gas:	$0.62	$4.00	6.45
Cost of a dozen eggs:	$0.82	$2.50	3.05
Cost of a gallon of Milk:	$1.68	$4.00	2.38

The increase in the price of gold is being driven in no small measure by the same type of herd mentality that has led to many other bubbles, and in fact the authors themselves seem to have fallen victim to its spell as well. Perhaps the best signal that a bubble is present and will soon pop is when the average investor starts to think: "Everyone is making a killing in gold, I should be invested in it too." It seems strangely perverse that a book with the stated mission to warn its readers against the dangers of investing in bubbles would then recommend investing in gold, which appears to be caught in a bubble that could pop at any time.

Recommendation 3: *Fall in love with leaps. "We love LEAPS!"*

Long-term Equity Anticipation Securities (LEAPS) are option contracts that allow investors to establish positions for 1 to 3 years. LEAPS can allow investors to profit from falling stock prices because they allow the holder to sell the security covered by the LEAP at a specified "strike price" during the term of the contract. Thus, a LEAP sets a floor on what an investor will get paid if they sell the stock covered by the LEAP. If stock prices fall during the term of the contract, the value of the LEAP contract rises. It's no wonder then, why the authors love LEAP.

More specifically, a LEAP is a form of a derivative contract. The price at which an investor can buy or sell a LEAP contract is "derived" from the trading price of the underlying security. Several factors influence the price of a LEAP, including the length of the contract and current market volatility levels. The difference between the LEAP's strike price and the underlying security's market price is said to be the LEAP's "intrinsic value". Importantly only the intrinsic value component of a LEAP's price is objective. The time and volatility components are subjective and set by market forces of supply and demand. Moreover, LEAPs are traded very infrequently relative to most other investments enhancing the possibility that at any given time the LEAP will be priced substantially above the LEAP's theoretical value.

As a result, it is possible for the stock market to drop and to still lose money on a LEAP that was designed to profit if stock prices fell. That could occur if there was a high level of market volatility when the LEAP was purchased causing its price to be inflated at that time. Accordingly, while LEAPs can be an effective stock market hedge, investors need to make sure that they are not overpaying for the protection the LEAP is intended to provide.

Consider, for example, the current pricing structure of a LEAP contract for the S&P 500 ETF (symbol: SPY) with the longest expiration date.

> On November 10, 2011 SPY closed trading at $123.16. A LEAP contract that expires in December 2013 and gives the owner of the LEAP the right to sell SPY at a strike price of $120, closed trading on November 10, 2011 at a price of $20.56. For the purchase of the December 2013 $120 LEAP on SPY to be profitable, the S&P 500 would need to decline to 999.44 representing the difference of the $120 strike price less the $20.56 cost of the LEAP multiplied by a factor of 10.[7] The intrinsic value component of the $22.65 cost of the LEAP is $3.16 (SPY closing price of $123.16 less the LEAP strike price of $120). The value of the time and volatility components in the current LEAP price are therefore $17.40 ($20.56 minus $3.16). But the theoretical value of the time and volatility components is only $10.81.[8]

In other words, the cost of the LEAP's time and volatility components are 61% higher ($17.40 versus $10.81) than the mathematically derived price. In short, the fear of a double dip recession has pushed the demand for protection from a sharp decline in stock prices to bubble like heights. As a result, if the stock market was to become significantly less volatile between now and December 2013, the LEAP could lose value even if the price of SPY fell between now and then.

The existence of that bubble makes the use of LEAPs to hedge against a decline in stock prices very expensive at the present time. Therefore if an investor was to blindly adopt the advice in Aftershock to "fall in love with LEAPs", they would be buying into the same sort of bubble that Aftershock correctly advises its readers to avoid. It appears that the age old adage that "love is blind" applies to investments as well as romance.

<u>Recommendation 4.</u> *Trade dollars for Euros. Put your cash in Euros. As the most liquid alternative currency, the Euro will soar as the dollar collapses.*

Aftershock advises its readers to trade dollars for Euros, and other foreign currencies. The rationale for this advice stems from the authors' belief that "the demand for dollars is driven

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7 A factor of 10 is used because each contract covers 100 shrares.

8 Myron Scholes and Fischer Black received the Nobel Prize in Economics for the formulation of Black-Scholes option pricing model. The Black-Scholes option pricing model currently sets the theoretical value of the time and volatility components at just $16.27.

by the demand from foreign investors to purchase U.S. assets, and the demand to purchase U.S. assets will fall".

This understanding of the demand for dollars is overly simplistic, and ignores some very important considerations that impact the value of the U.S. dollar relative to other countries' currencies. One such consideration is the well established phenomenon referred to as the "flight to quality", which can be described as the flow of funds from riskier to safer investments in times of economic uncertainty or danger. This is why the dollar tends to appreciate in value when times get tough. Every time there is an economic hiccup elsewhere in the world, the number of buyers for Treasuries increases, demand and prices go up, and yields fall. Foreign investors and banks are drawn to the dollar's relative safety like moths to a flame.

To be sure, the Federal Reserve's Treasury purchases under QE1 and QE2 are partially responsible for the reduced rates earned on Treasuries. However, even without the Federal Reserve's purchases, demand for Treasuries is projected to continue to increase dramatically because investors worldwide still view the U.S. Treasury market as the lowest risk asset with the highest probability for the return of the capital invested at maturity. Illustrative of this point is the sharp decline in Treasury bond yields last week as the U.S. sucked in capital from Europe – the traditional flight to quality that has occurred frequently since 2008. The rate of interest the U.S. Treasury must pay to attract purchasers of newly issued bills, notes and bonds remain at historically low rates.

3. What Do We Think?

There is near universal agreement that the massive deficit-financed spending the federal government has embarked on over the last 3 to 4 years cannot continue indefinitely. But while the authors' concerns regarding the extent of the federal deficit are legitimate, there are important considerations the authors either ignore, or fail to adequately consider.

For one, while tax revenues have been adversely affected in recent years by the recession, they should increase as the economy improves. In fact, there is evidence that this has already begun. State tax revenues in the second quarter of 2011 rose by a strong 10.8 percent from a year ago according to just released data from the Rockefeller Institute and the Census Bureau. Moreover, the rise in state tax revenues during the entire 2011 fiscal year (which ended on June 30th for 46 states) was the strongest since 2005. Therefore it is safe to say that once the economy improves, federal tax revenues will follow suit.

Aftershock also expresses the opinion that for federal revenues to go up, tax rates must be increased. The authors assert that the political consequences of raising taxes make doing so a near impossibility. Ignored is the fact that the federal deficit could also be reduced by decreasing government spending, or by increased private sector economic activity (which would result in increased tax revenues with no increase in tax rates). Once again, state governments have already taken the lead in this regard, where significant spending cuts are already on the books.

In addition, while the first stimulus package boosted government employment, it has been falling significantly as of late. More specifically, in August of 2010 the number of government employees was less than it was in 2008 when the Great Recession began. And in its recently released October employment report, the Labor Department said government employment continues to trend lower, having declined by 24,000 in October, 2011 alone.

Aftershock directs a great deal of criticism at the Federal Reserve's purchase of financial assets during the height of the 2008-2009 economic crisis, including the purchase of mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac. The authors fail to mention, however, that:

- The Federal Reserve made a record $78.4 billion profit on these investments in 2010.

- Aftershock also fails to acknowledge that much of the increase in the money supply has resulted in an increase in excess bank reserves deposited with the Federal Reserve.

- The Federal Reserve pays just one-fourth of one percent interest on $1.6 trillion in excess bank reserves. Those excess reserves deposited with the Federal Reserve provide the funding to purchase the long term, higher yielding bonds under the QE1 and QE2 programs. The difference between the interest received on the bonds purchased less the interest paid on the excess bank reserves, will continue to generate annual operating profits at the Federal Reserve.

- The Fed also earned $3.4 billion in interest from credit extended to American International Group Inc. (AIG) and its subsidiaries.

All told, the actions taken by the Federal Reserve in the height of the Great Recession have produced about $125 billion in profit which has been paid to the U.S. Treasury as required by law. Better still, the Federal Reserve stands to make much more on the investments it still owns and acquired as part of QE1 and QE2 as those investments are liquidated in the years to come.

Another significant consideration not addressed in Aftershock is the increased awareness of the extent of the government debt and the need to address it by the general public, as evidenced by the rise of the Tea Party. In most cases, change comes to Washington, not from Washington.

For these and other reasons it is not inconceivable that voters will force America's politicians to finally get their acts together. In fact, the increased attention being paid to the deficit makes this possibility more likely than not.[9]

4. What Can You Do?

While there are numerous reasons to question both the predictions and recommendations found in Aftershock, it also highlights legitimate reasons for investors to be concerned. The most recently released comments from the Federal Reserve contained the following cautionary statements:

> "[R]ecent indicators point to continuing weakness in overall labor market conditions, and the unemployment rate remains elevated. … [T]here are significant downside risks to the economic outlook, including strains in global financial markets."

Since its inception Estate Counselors, LLC has been advising our clients that they ought to consider defensive measures to protect their portfolios against the possibility of a Black Swan event, and have recommended different ways to hedge their portfolios against that risk.[10] Some of the ways to prudently hedge against a Black Swan event include:

1. Avoid long term bonds. This is consistent with what Aftershock recommends, and has been a consistent recommendation of ours since 2008.

2. Invest in TIPS. Treasury Inflation Protected bonds or "TIPS" are treasury securities that are indexed to inflation in order to protect investors from the negative effects of inflation. TIPS are considered a very good hedge against inflation because they are backed by the U.S. government and since their par value rises with inflation, as measured by the Consumer Price Index, their interest rate remains fixed. Estate Counselors, LLC has also been advising our clients to invest in TIPS since 2008.

3. Increase portfolio allocation to defensive oriented securities. A defensive stock is one that tends to remain stable under difficult economic conditions. Defensive stocks include food, tobacco, oil,

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[9] The next big indication of whether progress is being made in this regard will be a report by the Congressional "Super Committee," due by November 23rd. The Committee has been assigned the task of to squeezing $1.2 trillion out of the federal budget over the next ten years. If the Committee can't come up with an agreeable plan (which seems more likely each passing day), then the cuts are supposed to kick in automatically.

[10] A "Black Swan event" is one whose occurrence would not normally be expected and that would be extremely difficult to predict, but can be explained after the fact with the benefit of hindsight.

consumer staples, and utilities amongst others. These stocks tend to hold value in tough times because demand does not decrease as dramatically as it may in other, more discretionary sectors. By the same token, defensive stocks tend to lag behind the rest of the market during economic expansion because demand does not increase as dramatically in an upswing.

4. Utilize Collars. A collar consists of one "long" (purchased) put and one "written" (sold) call on the same underlying stock. The primary reason for utilizing a collar is to protect the current value of a portfolio from sharp declines. If the premium received from writing the call equals the cost of the put, the investor is obtaining downside protection with little out of pocket cost.[11]

5. Implement a "barbell" asset allocation. A barbell asset allocation involves investing in securities that fall in one of two groups; defensive (which makes up one end of the barbell) and growth (which makes up the other end of the barbell). Unlike a traditional diversified portfolio, investments with a more balanced risk profile are excluded from a barbell allocation. Empirical studies have shown that a barbell asset allocation is less susceptible to Black Swan events than a portfolio that is broadly diversified.

While the foregoing measures are examples of investments that can help protect a portfolio from tough economic times, it is important to recognize that the best time to adopt a more conservative investment approach is when times are good, rather than when times are bad. That's because in bad times safer investments cost more and risky investments cost less. So if you have realized you would be more comfortable with a less risky portfolio, the best time to adopt it would be after the nation's economy has recovered. However, if riding out the current down cycle will cause you undue stress or worry, then by all means consider adopting a more conservative asset allocation sooner rather than later.

Lastly, and very importantly, if an investor concludes that they were mistaken about their own tolerance for risk, and therefore decide to adopt a more conservative asset allocation, it is very important not to compound their first mistake by adopting a more risky asset allocation as soon as economic conditions start to improve.

III. Concluding Remarks

Much of the attention being given to Aftershock relates to the authors having predicted the bursting of the real estate bubble before the severity of the bubble was well known. The

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[11] Other option contract strategies that could be considered include selling cash covered puts in lieu of purchasing securities that are included in the client's model portfolio and overweighting in cash and purchasing out of the money option contracts that should rise in value if stock prices rise.

authors deserve to be commended on this insight.[12] Unfortunately history makes clear that the fact a market prognosticator was right once before (or even many times before) is little reason to give any additional credence to their predictive abilities going forward. As Warren Buffet once said: "The only value of stock forecasters is to make fortune-tellers look good".

The dire predictions found in Aftershock and elsewhere appear to be overstated, and radically changing one's investment portfolio in response to those predictions would be exceedingly risky. However, for some investors it may make sense to alter their investment allocations not because they are trying to time the market, but rather because current conditions have caused them to realize that they have less tolerance for risk than they originally believed.

<u>End of Memo</u>

[12] An argument could be made that while the authors' prediction regarding the collapse of the real estate market was correct, the reason for the collapse was different than what they predicted would be the cause. However, for the purposes of this memorandum, I am assuming arguendo that the correctness of the prediction was a result of their analysis having been born out.