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**Got a "hot stock tip"?**

*Save the gambling for Vegas. There's a difference between investing and speculating:*

*Speculators make decisions based on what they read or what they hear without investigating further. Buying Cramer's "Mad Money" tip is pure speculation.*

*Intelligent Speculators are a contradiction in terms. They think they know something others don't but ultimately are leaping to conclusions. We all know China is booming, but that doesn't mean we should buy no matter the cost and risk.*

*Intelligent Investors according to Benjamin Graham (Warren Buffett's mentor) are those who, upon thorough analysis deliver safety of principal and an adequate return.*

*MMM's investment principles are to protect your assets and to generate a healthy return while providing sound financial advice.*

[www.mmmwealth.com](http://www.mmmwealth.com)

## Q3-2007 MARKET RECAP

Investment markets were highly volatile during Q3-2007. A significant correction took place during late July and early August, followed by a quick rebound in September. During the correction, a high-level of fear gripped the investor community. Credit markets tightened, and people worried about the solvency of mortgage brokers, banks, and their own personal investment accounts. In some respects, these fears were indeed warranted, as the financial situation had deteriorated so rapidly. So what really happened? Most of what occurred began with a large number of defaults on adjustable rate, sub-prime loans, specifically those made in recent years to home buyers whom had provided no documentation of their personal incomes or balance sheets. As the adjustable component of their loans reset to higher rates, borrowers could not afford the higher payments, and therefore, went into default.

Generally, loans don't stay with the originating bank, but rather, are sold off to other institutions. So as the number of defaults increased rapidly, the market for selling these loans dried up and prices dropped to pennies on the dollar. Originating mortgage companies and banks which had issued new loans could not find buyers to unload these commitments.

These companies were facing bankruptcy almost overnight. In fact, over 100 smaller sub-prime mortgage companies did go bankrupt during Q3. Additionally, the companies and investors that had previously purchased these loans suddenly had huge losses on their books because of the rapid and significant price decline. Investors in these companies and funds feared the worst and began to demand their money back. As an example, a couple Bear Stearns funds lost 20-30% of their value in 1-2 weeks, resulting in unprecedented redemption requests from their clients. Consequently, these funds had to liquidate many of their investment holdings to give cash back to their investors, selling good investments as well as bad just to meet the redemption requests. This vicious cycle resulted in price declines across the board, regardless of the quality of the investment.



The correction of Q3/07 was an example of a classic confidence crisis, which panicked investors into taking the market down 8-10% in the US and Europe, and up to 20-30% in emerging markets. A similar crisis occurred at the start of the Great Depression. The major difference between the relatively short 2007 crises and the multi-year crises of the 1930s was how the central banks responded. In the 1930s, the central banks tightened the market even further, causing an incredible depression of prices (e.g. The Great Depression). Conversely, today's central banks responded by flooding the markets with liquidity (e.g. printing new money) and reducing interest rates to stimulate investment. This response led to a return of confidence. While we are not yet out of the woods, liquidity is improving, and depressed asset prices are more appropriately focused on the real estate and financial sectors. Additionally, the global economy continues to grow with ongoing strength from the BRIC markets (Brazil, Russia, India, and China) and the resources that are required to sustain their growth (metals, agriculture, oil).

## PORTFOLIO REVIEW

MMM portfolios were positioned conservatively ahead of the Q3 panic. This stance had cost the portfolios some relative underperformance during the first half of 2007, but was rewarded in Q3 with a limited draw-down during the correction. Additionally, we became more aggressive (more heavily invested) in mid-August when most investors were running for the exits and calling for a recession. The net result was a higher return relative to market for our Active-System clients. For our Buy-and-Hold clients, we were positioned less con-

servatively due to the nature of the strategy, and consequently, we trailed the market as some of our real estate investments incurred major losses. As an example, there is currently a law suit pending against American Home Mortgage who quickly went bankrupt after allegedly misrepresenting the company's finances. This single investment contributed a 2 - 3% loss to our Buy-and-Hold client portfolios. Clients should review their individual reports for specific results.

## MMM COMMENTARY

We received a few phone calls and emails from nervous clients who were wondering whether we should be selling assets during the recent Q3 panic. As always, we encouraged these clients to focus on the long-term and they all agreed to stick with the plan. It is common for retail investors to sell during panics (sell low), and buy during bubbles (buy high), significantly hurting their long-term returns. This phenomenon is an outcrop of the basic human emotions: fear and greed. During panics, fear kicks in, causing people to sell. During bubbles, greed and fear both kick in, encouraging people to buy more in order to keep up with what they believe others are doing. To make matters worse, Wall Street brokers are often paid on commissions, encouraging this excessive trading to bolster their incomes. DALBAR, an independent financial services research firm, conducted a ground-breaking study on this phenomenon in 1998. For the 15 year period leading up to 1998, the S&P 500 returned a

cumulative 820%, while individual investors returned only 140%! Essentially, individual investors captured only 1/5<sup>th</sup>

*“The primary drivers of underperformance are overconfidence, the following of trends, and the emotions of fear and greed.”*

of the potential market gains. While some of the underperformance was attributed to diversification into lower yielding assets like bonds, their analysis uncovered that the primary drivers of underperformance were overconfidence, the following of trends, and the emotions of fear and greed. This phenomenon continues to exist today, as the statisticians recorded massive inflows of money into the market during the Q2 peak and massive outflows during the Q3 panic. These investors essentially bought high and sold low, thus realizing 7-10% losses.

What does all this mean? From our perspective, it means

that investors not only have to think differently than others, but have to control their emotions better than others as well. In order to capture outsized returns, we believe in the following cardinal rules:

- Focus on the long-term
- Reduce your emotional attachment to short-term results
- Stick with a proven system that protects and grows your wealth

We are fortunate to work with great clients that embody the above principles and are willing to act contrary to the crowd when appropriate. Clients are encouraged to be cautious when the markets are excited, and to be opportunistic when the markets are fearful. We applaud our clients for their methodical focus on long-term saving and investing. Best of all, we are pleased that our clients are enjoying life and it's various pursuits, instead of worrying about month-to-month and quarter-to-quarter account balances.

*We are available to discuss any questions you may have regarding our progress towards your investment and financial objectives.*

*Please call or email us to schedule a time to review.*

Ph 303-777-7424  
 Mob 415-793-8014  
 Fax 509-695-8491  
 Email [info@mmmwealth.com](mailto:info@mmmwealth.com)

As always, we encourage you to pursue life's dreams as we manage, protect, and grow your wealth.

Warm Regards,



Raphael and Megan Martorello