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### DIAMOND IN THE ROUGH

Turn to MMM's "4 C's of Investing" to guide you through these times.

#### Cash

Keep a cash reserve outside of your investments. This will help you find comfort in knowing you can deal with emergencies without cashing out your investments when the market is down.

#### Control

It's important to control discretionary spending and examine ways to lower some of your larger fixed costs.

#### Courage

By adding to your savings, you continue to make progress towards your goals and from an investment standpoint, new savings are buying in at low prices.

#### Commitment

Renew your focus on the long-term and have an optimistic outlook, knowing that markets move in cycles and this will eventually pass.

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## Market Recap

Q3-2008 ushered in an unprecedented period of volatility and unpredictability in U.S. and global financial history. While the groundwork for the current situation was laid many years ago through an enabling Congress, aggressive lending practices, and a populace reaching above their limits, the final chapter began to rapidly unfold in Q3. As real estate values continued to plummet, the mortgages owned by banks massively declined in value. The banks were forced to take losses on these assets, and began scrambling to raise cash in any way possible. The easiest way was to sell shares or have a capital infusion from a different firm or from another country who was interested in buying into some of our most iconic bank brands. When that source of capital dried up, the banks looked to where they were lending money. One of their main borrowers are hedge funds, who operate on great amounts of leverage using strategies that generated 2-3% returns but were leveraged by up to 40-to-1, creating 80-120% returns off of the 2-3%. The way this would work is as follows:

- A. A client would give a hedge fund \$100,000.
- B. The hedge fund would post this money to a bank as collateral, and the bank would lend them 40 times this money or \$4,000,000. This is very similar to people being able to buy a \$1,000,000 home with only 5% down (that would be 20 to 1 leverage).
- C. While times are good, this arrangement worked out and everyone made lots of money (the banks, the hedge funds, home owners, and hedge fund investors)

When the banks needed to raise capital because of their mortgage problems, they forced hedge funds to "lever down" to 20-to-1 or 10-to-1 ratios, instead of 40-to-1. These hedge funds were put in a difficult situation, and were essentially forced to sell 50-75% of their assets just to return money to the banks. Regardless of the quality or fundamentals of their investments, these hedge funds sold assets indiscriminately, resulting in a spiraling down of stock market prices. On the outside, these price declines appeared to be illogical, as very strong and fundamentally sound investments were declining faster than poor investments. Only in hindsight do we see what actually happened.

The next step in the de-leveraging process involved large financial institutions that went bankrupt or were purchased outright by stronger competitors. "Mark to market" accounting rules played a major role in these failures. While stocks are priced on a daily basis by being traded on stock exchanges, assets such as mortgages do not trade on a market, and so the accounting for them is tied to the last price paid by anyone in the private market place (called "mark to market"). This is similar to getting a "comp" when selling a home. There is no daily price tag on the front door of a home, so it is priced by comparing it to other recently sold homes in the neighborhood. When the weakest banks were forced to sell their mortgages, they did so at fire sale prices because they had no leverage in the negotiations.

## Market Recap (continued)

Due to mark-to-market rules, all other banks, regardless of their health, were then forced to mark their holdings to this most recent price as well...essentially forcing everyone to price their securities to the lowest common denominator. This was the final straw. The mark downs forced an even greater need to raise cash to make up for paper losses due to the write-downs. Hedge funds were then moved to 5-to-1 leverage or no leverage, and the selling cycle intensified. Major financial institutions began to go bankrupt (Lehman Brothers), get bought out (Merrill Lynch by JP Morgan-Chase), or get bailed out by the government (AIG, Fannie Mae, Freddie Mac). The carnage was not limited to just the U.S., as leveraged banks around the globe began to fail. Even healthy banks refused to lend to each other since they didn't know who would be around the next day...cash was hoarded.

Unfortunately, what started as a financial credit problem has now spilled over into the general economy. Banks refused to lend to companies and people that required credit. Companies and farmers couldn't get loans to buy inventory and make their products / crops. People couldn't get loans for car or home purchases. Even municipalities in cities and states couldn't raise any funds to pay off their general obligations such as teacher's salaries, etc. Consequently, without credit flowing, our economy, and the economies around the globe came to a standstill, and stock markets around the globe reacted violently and rapidly through Q3 and now the beginning of Q4.

## Rescue Plan(s)

Over the past year, the U.S. Federal Reserve and Treasury have addressed issues as each arose on a one-off basis. However, both of these institutions underestimated the severity of the situation. Additionally, European and emerging market countries somewhat ignored the problem and restricted credit further by refusing to reduce their interest rates. A globally coordinated policy was required, but world leaders were late to this realization. By the time the problems began to unfold more dramatically in Q3, the global programs that were finally proposed could only hope to minimize rather than solve the problem.

In recent weeks, great progress has been made in architecting various coordinated solutions. However, they will take weeks or months to implement, and with each day that credit isn't flowing, the stock market has dropped further and Main Street America is suffering due to company closures, layoffs, and reduced consumption related to a lack of credit availability. We will not get into a political discussion on whether these programs should or should not be part of a free market system, but we do have to understand their impacts on investment markets.

The programs are now beginning to be implemented, and we are seeing some improvements in credit markets, albeit at a slow pace.

- Global coordination by governments to temporarily guarantee loans will allow banks to lend to each other with reduced risk of default. This is the first step in unfreezing credit markets.
- Global interest rate cuts will reduce the costs of borrowing where it is available. Despite widespread reporting and panic about limited borrowing, the media is sensationalizing the problem as there are many banks that continue to lend to strong businesses.
- The \$700B TARP program passed by the U.S. Congress has a number of very positive features that are being implemented:
  - ▶ \$700B will be used to help clean up balance sheets and restore lending
  - ▶ FDIC insurance on bank deposits has been raised from \$100K to \$250K and to unlimited levels for non-interest bearing accounts.
  - ▶ AMT tax relief will help keep money in middle-class pockets
  - ▶ A marketplace / exchange is being contemplated to post mortgage assets out in the open for all banks to be purchased by private investors. In doing so, this solution will provide banks with visibility to each other's liabilities in the short-term, so they will know who they can or can't lend to. Consequently, this should take the place of the temporary guarantees by government described above...as the banks would now have the confidence to know to whom they should or shouldn't lend their money. Furthermore, over the longer term, this would not allow banks to hide their losses for long periods of time, reducing the risk of a repeat situation in the future.
  - ▶ Direct cash infusions through investments in U.S. financial institutions to improve their balance sheets and increase confidence in the system.
- A new economic stimulus plan is being contemplated by Congress to help bridge the gap between our current credit-induced weakness and a post TARP plan implementation.
- Private money coming in from deep pocketed investors like Warren Buffet are creating a floor in equity market prices, as smaller investor see leadership from these individuals and get back their faith that we will come out of this crisis.

The U.S. and global economies are resilient and we believe that the aforementioned will begin to have a positive effect in the near future.

## Client Portfolio Review

It goes without saying, that Q3 2008 was a very difficult and trying time to be an investor. Emotions ran wild, markets moved rapidly, and these emotions temporarily trumped logic. Multiple decisions needed to be made on a daily basis. At MMM, our first task at hand was a systematic review of our brokerage partner TD Ameritrade (TDA) during the July-August time period. With some investors and depositors losing their entire net worth at other financial institutions, we scrutinized TDA to understand their financial health, money market stability, and investor protections for our clients. Our analysis revealed that TDA had no exposure to mortgage-backed securities, primarily because they were a brokerage-only business model and did not have an investment bank like other failing institutions. Additionally, TD Ameritrade was backed by a traditional bank in Toronto Dominion, the safest business model for all brokerages because the bank had a base of stable depositors.

Since that time, leading independent investment banks have either gone bankrupt (Lehman Brothers), been purchased by a bank (Merrill Lynch being acquired by JP Morgan Chase), or have converted to banks themselves to increase their deposit base (e.g. Morgan Stanley and Goldman Sachs). We also reviewed TDA's money markets and found that they had no risky asset exposure for our specific client accounts. Finally, we reviewed TDA's SIPC insurance for client accounts and their reinsurance programs through Lloyd's of London. All in all, we felt comfortable with our brokerage partner TDA, and felt comfortable that our clients would not be lining up outside of their doors trying to get their money back, as other investors have had to do with select financial institutions.

The second task at hand was to continue defensively positioning client portfolios within an unfolding bear market. Q3 ushered in a liquidity crunch, described earlier in this newsletter, which resulted in defensive and higher quality investments declining by even more than the general market or lower quality investments. Our diversified approach achieved its primary objective of protecting against catastrophic loss (e.g. those that held concentrated positions in AIG, Lehman, Washington Mutual, Regional Banks, concentrated Hedge Funds, or selected local real estate investments who lost everything). However, fundamentals were thrown out the window and illogic prevailed. Consider the following:

- The financial sector rose in value, despite individual companies going out of business
- Safer sectors declined 2x to 3x the general market due to forced selling described above
- Quality corporate bonds with high yields declined due to poor access to funding

*We are proud to report that our entire client base (100%) has stuck with the program.*

- Stable currencies like the Australian and New Zealand dollars dropped due to carry trade unwinding (owning high-yielding currencies while selling low yielding currencies)
- High-yielding bonds declined beyond all rationale levels (e.g. Leverage World, a weekly publication of Garman Research indicated that September's drop was an occurrence that should have occurred only once in 27,000 years).

In addition to the above, the market's volatility reached unprecedented levels as illustrated in the Volatility Index (VIX) chart below:

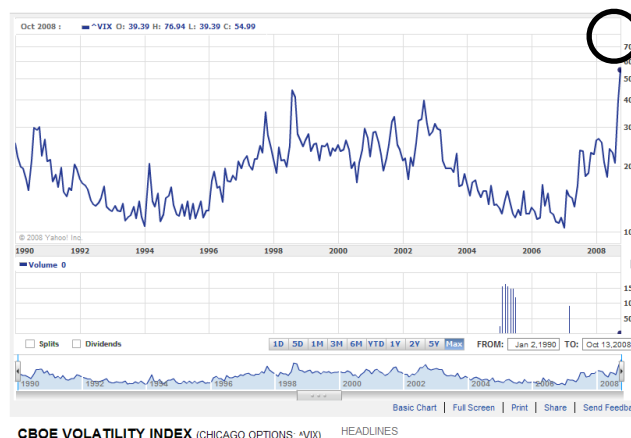


Figure 1: Volatility Index (1990 - 2008)

Why was volatility an important factor in portfolio returns during the short-term of Q3-2008? The choppiness of the market was so pronounced, that an investment decision made in the morning could be completely different by the afternoon. ...movements that typically occur over 3-6 months were occurring in 24 hour time periods, oftentimes due to unpredictable government announcements about passages or failures of certain programs, bailouts, or banks. Further exacerbating this issue was the structure of client 401K accounts which could not be traded intra-day but had to wait until day-end for purchases or sales to be made.

With volatility peaking and negative news coming out of every media outlet, many individual investors have fared far worse than the market by locking in their losses to cash. As of this writing, there was a climactic low on October 9th (post Q3) where many individual investors sold their positions in a moment of fear and panic...only to watch the markets rebound 15-20% over the next two trading days. At MMM, we view our client counseling during excessive times of panic as a major value-add. As of this writing, we are proud to report that our entire client base (100%) has stuck with the program, in some cases making minor tweaks based on their budgets and risk tolerances. Clients have overcome fears, have not locked in losses by moving to cash, and have positioned themselves for the next bull market that will materialize at some point in the future.



## Client Portfolio Review (continued)

As is always the case, it is important to learn from history, and this period will have many new investment lessons from which to learn. In time, we will do a full review of our market indicators, asset selection techniques, and protective tools to see if there are improvements we can make for similar periods in the future. With that being said, we have experienced a very highly improbable set of occurrences and we would not want to become overly cautious in future downturns that are more traditional in nature. Here are the improvements we have already considered and implemented:

- Additional liquidity indicators to better measure credit market conditions
- More conservative asset selection when declines exceed the typical 10% correction
- Faster trailing stop rules when markets accelerate to the downside

Additionally, we will be engaging in new research around the following areas:

- Effects of our globally integrated world on traditional diversification theory
- Effects of government intervention during times of market strain.
- Exploration of futures and foreign currency trading strategies with sub-account managers for a portion of client portfolios to add uncorrelated asset classes.

We hope to provide you with more details regarding our findings and adjustments over the coming years as we continuously strive to improve our capabilities around asset protection and growth for clients.

## Market Outlook

In last quarter's newsletter (Q2, 2008), we discussed the human phenomenon of extrapolating current events into the future improperly. Our example included the price of oil which was priced in the \$140-150 per barrel range. Analysts and the general population were predicting \$200-300 oil. While we didn't realize that it would happen so quickly, oil corrected over 40% to \$80-90 per barrel within the 3 short months. Similarly, as gut wrenching as it may feel, the recent decline in the stock market should also not be extrapolated down to the ultimate level of total loss (0%).

In our opinion, talk of a second Great Depression is extremely exaggerated. During the Great Depression, the government responded to a credit crunch by raising interest rates, tightening credit, and raising taxes which stifled growth. Today, central bankers are dramatically loosening credit. Ben Bernanke, our current Fed Chairman, is one of the leading researchers of the Great Depression and he is using every tool possible to avoid a similar fate. Additionally, the US Treasury, led by Henry Paulson (ex CEO of Goldman Sachs) is acting swiftly and grandly to reduce the impact of the current situation.

With that being said, there are some real economic benefits to bear markets:

- Crooks and cheats are rooted out while the strong and ethical survive. For example, many bad CEOs have been fired, jailed, and lost personal fortunes, while good CEOs and businesses have bought their rival's companies and are thriving.
- Many unemployed individuals retrain in new industries or creatively build their own businesses out of necessity, building the foundation for the next wave of growth.
- Productivity surges as companies reduce their headcount during tough times and improve their profitability into the next up cycle.
- There is a general purging of excesses as companies, individuals, and governments get back to the basics.
- Housing, energy, and food prices tend to come down, which makes living more affordable for retirees and entry-level opportunities more available for our youth.

As we move forward, we offer the following thoughts and recommendations for our clients.

### Short-Term

Have a safety net of 3-6 months cash for emergencies and make sure you have positive cash flow (increase incomes and / or decrease costs). This will allow you to ride out any storm and stick with your investment plan, while having a safety net. After that, stop watching the doomsayers on CNBC, and go live your life.

### Mid-Term

The market will turn back upward before the economy does. A great deal of stimulus has been put into the system, and it will take some time for it to kick in and for investor confidence to fully return. During the S&L crisis of the late 80's and early 90's, over 1000 banks failed after the market had already turned to the upside. Markets can deal with bad news and good news, but have trouble with uncertainty. As soon as TARP and other programs are rolled out, there will be greater clarity on the new status quo, the markets will rapidly adjust upwards or downwards to reflect the new reality and we will build from there. Typically, large gains are realized in the first 12-18 months after the market bottoms and turns. Being invested during this time period is extremely important. If you have money on the side-lines, you may want to start putting those funds to work, especially after the Presidential election is complete and the country begins a healing process.

### Long-Term *(Our recommendations are different by client profile:)*

#### Younger Clientele

This bear market is an incredible gift to you as it offers opportunity to buy investments at bargain prices. Additionally, you will have the chance to get into a starter home at prices far lower than they were two years ago. Be aggressive, invest through the bear market, and be excited at the deals you are getting.

#### Middle-Aged and/or With Reasonable Accumulation of Assets

This market presents both a negative and a positive. While you may be feeling bad about current balances being temporarily down, there should also be excitement that the next 20 years will find these assets rebounding and surging beyond previous peaks. Additionally, there is opportunity for your current and future savings to be invested at today's reduced prices. Continue to commit to your savings and investment plan, and focus on the longer-term.

#### Retirees and Pre-Retirees

If you have large assets, this may be a good time to relook at your asset allocation model across all investments (public markets, private markets, and real estate), managers, businesses, and approaches, to ensure that you have a comprehensive approach to achieving your long-term plans. "Safe" doesn't necessarily mean cash, CDs, or bonds...but the ability to outpace inflation and not outlive your assets.

If you do not currently have enough money to fund your retirement, 75 may be the new 65 when it comes to your working life. People live 13 years longer today than they did in the 70s, so they can be more productive, and need to be in order to service more years of life. Most importantly, get to a positive cash flow situation without your investments, continue to save if you can, and you will still have a 5-10 year horizon to grow your nest egg. You've beaten previous economic downturns, survived wars, achieved civil rights and women's liberation and in these current times, we too will get through this and emerge stronger on the other side.



## Market Outlook (continued)

Regardless of your situation, cash in the mattress, CDs, and T-Bills are not a long-term solution...they are a guaranteed approach to losing against inflation. Being invested in equity markets is the only strategy for success over the long-term, and as long as you can remain focused in that regard, the odds are tremendously in your favor (see Figure 2):

It can sometimes be challenging to stick with your plan when markets are down so much and everyone is talking so negatively. However, the magic of long-term compounded returns is available only for those that can persevere and have faith in the future. You cannot always control events, but you can control your responses to them.

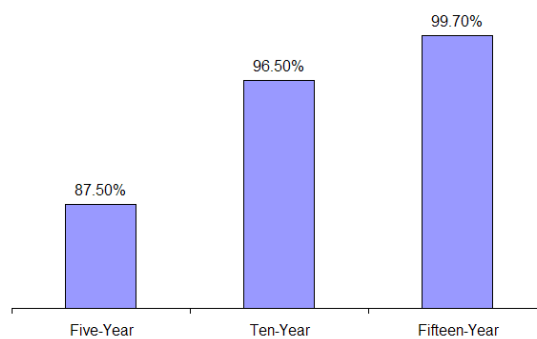


Figure 2: Percentage of Rolling Periods with Positive Returns for the S&P 500, 1926 - 2006

If you don't have a plan, we want to hear from you. If you don't have a safety net or have cash flow issues, we want to hear from you. If you can't sleep at night right now because of the markets and your concern about them, we want to hear from you. This is not a time for any of us to crawl under our mattresses and retreat, but rather to face up to the situation and have a plan for moving forward. As Franklin D. Roosevelt once said, "the only thing we have to fear is fear itself."

We look forward to hearing from you, and as always, encourage you to pursue life's dreams as we help to achieve your long-term goals.

Warm Regards,

Raphael & Megan Martorello  
 MMM - Martorello Money Management, Inc.  
 LotusGroup Advisors, LLC.

## QUESTIONS?

As always, we are available to discuss any questions you may have regarding our progress towards your financial and investment objectives.

## REFERRALS?

We appreciate your referrals as they are the lifeline to our business. Please let your family, friends and colleagues know about our wealth management services.

## Contact Us

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