



AUBRY & EUSTICE

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“The issue here is **fear**: not what the market is doing, but how you are reacting to what the market is doing.”

- Nick Murray

“Fear has a greater grip on human action than does the impressive weight of historical evidence.”

- Dr. Jeremy Siegal and Peter Bernstein in their book *Stocks for the Long Run*

Who's Afraid of the Big Bad Wolf?

In capitalist economies, there are periods of expansion and contraction . . .

When measuring the health, or growth, of an economy, economists use GDP as their guide. GDP is a country's *Gross Domestic Product*. This measures the value of all goods and services produced in a country and is considered by most to be the best barometer of the country's economic health.

During the 3rd Quarter of 2007, the United States of America's GDP grew at a rate of 4.9%. The 4th Quarter of 2007 saw a dramatic slow down in growth, yet GDP still grew at a rate of 0.6% (we will soon hear what the GDP estimates are for the 1st Q of 2008). Why are these numbers important? Contrary to what many think and say, *the economy of the United States has not been in a recession*. The definition of a recession is “two consecutive quarters of negative growth.” And while the 3rd and 4th quarter numbers do show that there was a dramatic slow down in the growth of the economy, the economy still expanded none the less.

Are we in a recession right now? It is likely that we will not know until July or August. The question we should be asking is, “How does a recession affect us?”

Let's first determine *exactly* what a recession is. A recession is a period of time that has falling real output (GDP) as a result of a significant decrease in aggregate (overall) demand. What this means in everyday words is this: markets and prices of goods and services are moved, or changed, by the forces of supply and demand. Aggregate demand strongly influences economic production and growth levels. In turn, aggregate demand is determined, or influenced, by the power of the consumer to purchase; this ultimately directly influences hiring decisions and employment levels.

Recessions are perceived to be bad because they cause a decrease in employment. Unemployment is bad (for the economy) only if unemployment is too high for an extended amount of time. High levels of prolonged unemployment cause concerns because unemployed consumers will have less power to purchase goods and services. Again, if unemployment is too high for too long, businesses are likely to slow their production because consumers are buying less of the business' products or services. This causes businesses to tighten even more and hire even fewer people. A very vicious cycle.

(It is believed by some that prolonged recession and unemployment leads to psychological harm on the unemployed, such as increased alcoholism, poverty and crime. This may also lead to more Democrats in Congress and the White House. Democrats are historically more willing to institute government “programs” that appear to “create” more jobs. It can be argued that the current Bush administration has, especially in recent years, acted more in lines with historically Democratic practices rather than traditional Republican practices. However, this is not the topic of this newsletter.)

It is therefore desirable by most politicians to *do something* to “spur economic growth.” Thus, we, as the American investors, are led to believe that the government can fix everything. Thus the phrase in politics, and especially during a presidential election year, “It's the economy, Stupid.”

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In order to get out of a recession, the economy must increase its actual autonomous expenditure (consumption not induced by income). This can be done in a variety of ways, most notably: income tax cuts, investment tax credits, interest rate cuts or an increase in government spending. In an effort to “stimulate the economy,” we now have the recent “economic stimulus package.” And while I do not necessarily agree with what the current Bush Administration and Congress is doing, I am sure that if you receive a check from the government in the next several months, you are not going to give back the \$1200. You are likely going to spend it on the vacation your family has planned this summer, which is exactly what the government wants you to do!

Are we in a recession? We don’t know, and why should *we*, the American investors, really care? As noted earlier, a recession is noted by two *consecutive* quarters of negative growth. So far, we have not had *any* quarters of negative growth. On Thursday, March 27, the Commerce Department stated in its third and final installment that the Gross Domestic Product did indeed rise by 0.6%. Many commentators are using the word “feeble” in front of the 0.6%. It is like these commentators, talking heads and reporters expect that the economy should actually increase every quarter of every year. This is not possible. Recessions do, in fact, cause businesses to contract. But as investors, this is ultimately good for us. How? Because businesses are required by market forces to become more efficient, thus allowing us, as investors, enhanced returns through both growth *and* increased dividends.

It is proven that investors are compensated by two main factors: risk and time. Yet, when we encounter risks, like a recession, we want to cut the time that we want our investments to work. (“Let’s take some – or all – out of stock-based investments and find something safer until the markets recover and start going back up.”) This is exactly the opposite as to what should be done. However, if it really were possible to know when to get out or even back in – which it is not – it would be very labor intensive and therefore very expensive, likely robbing you of much of any potential gain you could get in this scenario.

Investors are rewarded for taking on risks – risks that *can not* be eliminated. In investing, there are two kinds of risks: *systematic* and *unsystematic*.

Systematic risks are inherent to the market. And for that, systematic risk is also known as “market risk” or “undiversifiable risk.” These risks ***can not be eliminated*** through diversification or proper asset allocation but they can be managed. Examples of systematic risks are: variable interest rates, wars, market expansions and ***recessions***.

Unsystematic risks on the other hand, ***can be eliminated***. These risks affect individual or a small number of assets. Examples of unsystematic risks are one company’s earnings, legal issues, etc.

Investors are only rewarded for risks that cannot be eliminated!

Just so everyone knows that there is more to this than mere anecdotal evidence, here are some numbers . . .the S&P 500 reached its highest point on March 24, 2000 and then dropped precipitously for more than 2 ½ years (October 9, 2002). For this example, let’s assume that we bought into the S&P 500 on January 1, 2000 with \$1 and then made no more investments (this is about 2 ½ months before the then peak). Let’s also assume that we had the fortitude to hold that position through thick and thin until December 31, 2007 – a full eight years. At the end of 2007, that dollar would have been worth \$1.14.

You may be thinking, “Why is this a good reason for me to keep doing what I’m doing. Sure, there was a recession, corporate scandals and the markets were dropping early in your example. But c’mon! Over eight years, \$1 turns into \$1.14? That’s only ***1.66%*** per year. That is not the type of annual return that I see as being a good return.”

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Portfolio #2. What if we added some diversification to our portfolio — and risk? While the S&P 500 represents large company stocks, the Russell 2000 represents small company stocks. If our dollar on January 1, 2000 was invested as \$0.50 in the S&P 500 and \$0.50 in the Russell 2000, our annual return would have been **4.24%**. Not the 10% that we would all like to get, but much better than the S&P 500 by itself.

Portfolio #3. If we add more diversification and more risk with \$0.25 in each of the following indices: S&P 500 (U.S. large cap), Russell 2000 (US small cap), MSCI EAFE (International large cap), MSCI EAFE Small Cap Index (International small cap). The return would have been **7.51%**.

Portfolio #4. Increased diversification and risk using five asset classes at \$0.20 in each of the following indices: S&P 500 (U.S. large cap), Russell 2000 (US small cap), MSCI EAFE (International large cap), MSCI EAFE Small Cap Index (International small cap), MSCI Emerging Markets Index (Emerging markets). The return would have been **7.97%**.

So, we now know that the United States' economy grew 0.6% in the 4th quarter of 2007. It was a paltry 0.6%, but it was not negative growth. Many economists believe that we are *definitely* in a recession now. **And as long-term investors**, even those of us taking an income from our portfolios, can confidently say, **“So what; we don't care!”**

So, **who's afraid of the Big Bad Wolf?** When you have a globally diversified portfolio, split along multiples dimensions of risk and return, you are just like the little pig that built his home of bricks. We can now welcome a recession from a long-term perspective, just as nature welcomes a forest fire. It is really hot, uncomfortable and potentially deadly if we make the wrong decisions during the fire, but the long-term benefits can not be overstated.

We speak a lot about the determinants of success for money and investing. There are three:

1. Have a plan
2. Proper asset allocation
3. Behavior Management

If you are working with us, you have a plan. Based upon our scientifically engineered portfolios, you have proper asset allocation. And we are, along with this letter, helping you with the discipline to make the correct decisions during the fire (or recession).

If we are, in fact, in a recession, as a long-term investor, the most important thing to do during a recession is to remember the three determinants of success; two you did before the recession started and the third, and likely the most important *during the recession*, is to have the discipline and fortitude to stick with the first two.

Lastly, continue to have faith in the future. Do not be afraid of the present and do not be seized by the tyranny of the urgent. Be strong and courageous! You are doing the right thing by having a specific plan to meet your long-term needs; it is the medicine that we know we have to take and know that it will make us better, but we are fighting it because it does not taste good.

To your discipline and success!



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Quarterly Performance (January 1, 2008 – March 31, 2008)

Very few people, if any, were happy with the performance of their investments in the first quarter of 2008. In fact, we have heard stories — horror stories — about how people have seen major declines in their portfolios and are very concerned about their futures. Unfortunately, these horror stories are not driven by data and science, but by emotion and poor decision-making.

For example, a recent *Wall Street Journal* article (Jennifer Levits, “Americans Delay Retirement As Housing, Stocks Swoon,” April 1, 2008), told us about:

- an IBM executive who lost 20% in his 401k and IRA account during the first quarter; and
- a Hewlett-Packard executive who is delaying retirement because of “wave after wave of bad economic news.” His portfolio lost over 12% in the month of January alone.

It is unfortunate that people must endure difficult times. However, difficult times are made more difficult because the *three determinants of success* are not at the foundation of an individual’s plan (having a plan, proper asset allocation and behavior management). Concerning the executives referenced above, I believe that each had a plan, but it is painfully obvious that both had neither *proper asset allocation* nor are they *managing their behavior*.

Both of these individuals — and they are not alone — must be in portfolios that are extremely volatile. For example, during the first quarter, the S&P 500 had a return of -9.45% and the EAFE Index (the index that measures developed international markets) had a return of -8.82%. Both are dramatically lower than the 20% lost by the IBM executive.

As discussed earlier in this newsletter, there are periods of expansions and contractions in capital markets; the *most important objective is to minimize loss in the bad times*. The key to doing this, especially when coupled with a slowing economy and the possibilities of being in a recession, is to have a globally diversified portfolio that affords you the opportunity to have both wide and deep asset class exposure.

Portfolio Performance

S&P 500	-9.45%	EAFE Index	-8.82
AFG 97	-8.41%	AFG 97 International	-8.44%
AFG 88	-7.58%	AFG 88 International	-7.61%
AFG 75	-6.28%	AFG 75 International	-6.3%
AFG 50	-3.81%	AFG 50 International	-3.82%
AFG 25	-1.39%		
	AFG Global Equity 100	-8.35%	
	AFG Global Equity 80	-6.32%	
	AFG Global Equity 60	-4.68%	
	AFG Global Equity 40	-2.96%	

Performance data represents past performance. Past performance is no guarantee of future results and current performance may be higher or lower than the performance shown. The investment returns and principal value of an investment will fluctuate so that an investor’s shares, when redeemed, may be worth more or less than their original cost. To obtain performance data specific to your account, call 877.857.7500. Performance numbers do not include investment advisory fees.