

Aubry & Eustice, LLC
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“The single biggest reason that people fail to achieve wealth in equities . . . is that they never really understand risk.”

- Nick Murray

“People fatally misperceive risk, in two distinct ways. They overestimate the risk of holding stocks, and underestimate the risk of *not* holding them.”

- Nick Murray

Is it really the Economy?

First of all, congratulations to President Elect Barak Obama on his historic victory. While we do not generally agree with his thoughts on how to administer the economy (at least those discussed during the election cycle), his election has altered the political landscape - forever. It is a testament to the Founders of this great republic that we can change leaders every four (or 8) years without the help of a *coup d'état* or the need to call in the military to keep the peace. It is also a testament to the people of the United States of America; hopefully we have moved beyond judging someone by the color of their skin.

The new Obama administration has a tough road ahead of it. It looks as if they may have to adjust, or at least delay, their time of delivery on many of the pre-election promises. A hard fact remains in that few Presidents ever are able to deliver on those promises, especially when coming into the White House during what could be a recession. It depends upon your political ideologies as to whether this is a good thing or not, but the current economic conditions in the U.S. have caused all politicians to rethink what it is they believe about the current economic environment.

As an interesting side note, five of the last six President Elects have ascended to the Presidency during, or because of, an economic slowdown or recession. Jimmy Carter, Ronald Reagan, Bill Clinton, George W. Bush and now, Barak Obama have all been elected during times of financial or economic upheaval. It makes one pause and think that maybe “it actually *is* the economy, Stupid.”

There are two reasons for pointing this information out. The first is that, at least relative to economic issues, it does not appear to matter which political party inhabits the White House. Recessions and expansions happen when both Democrats and Republicans occupy the most powerful political seat in the world. And, as we have written about in the past, the second reason for pointing this out is that we *will* get through this current malaise. Unfortunately, we are most likely going to experience more economic downturns and recessions in the future.

So, are we in a recession now? We wrote about recessions extensively in our Quarter 1, 2008 Newsletter (http://www.aubryeustice.com/pdf/1Q_2008.pdf), but to review, a recession is defined as two successive quarters of negative economic growth. And according to this definition, the American economy is *not* currently in a recession. Even though it may seem like we are, and the newscasts label it as such, we are not.

Please understand that we are not saying that things are fine and that no one is hurting. There is no doubt that certain industries, businesses and people are having tough times. Some businesses are going through a prolonged decline in business, and some areas of the country that have major industries present are in recession (Detroit, for example).

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However, the U.S. economy as a whole is not officially in a recession. It is being argued by many that, no matter what the official numbers say, we are in a recession. Some are even claiming that, not only are we in a recession, but we are at the beginning of a long, drawn-out and “deep” recession (“protracted recession” is a phrase you may have heard used by the “experts”.) There have been prognosticators predicting recession for the past 6 years, which highlights the funny thing about predicting recessions... if you predict one long enough, you will eventually be right. (As an aside, the two groups that are most damaging to our portfolios are prognosticators and politicians.)

You have heard us talk about this before: in economies driven by capitalism, markets expand and markets contract. And regardless of what the prognosticators and politicians lead you to believe, there is nothing that can be done to stop these periods of expansion and contraction. We can try to slow the effects of a contraction or speed up the expansion, but there is nothing we can do to completely stop this cycle. These periods are economic inevitabilities.

Some may question, “Why did the government do so much, or so little in some cases, since March of this year? Bear Stearns, Fannie Mae, Freddie Mac, Lehman Brothers, AIG? Is the Government going to help the auto industry? So far, we at Aubry & Eustice believe that the government has acted appropriately, with the exception of the pork that made its way into the most-recent “bail out” package.

There is currently another “stimulus package” being discussed in Washington, D.C. The first stimulus package of 2008 was signed into law back in February and was received by many Americans this summer and appeared to do little in stimulating the economy. Aubry & Eustice believes at this time that another stimulus package would neither create an immediate “jump start” to the economy, nor would it cause enough of an impact to have any effectual change on the current economic slowdown, malaise or possible recession.

How did we get into this mess?

Beside the fact of the economic inevitabilities, there are a number of contributing factors to this, which you have probably heard discussed before, but one that we are almost certain that you have not heard discussed. It may surprise you to learn that it is not necessarily because of “Wall Street’s greed.”

In the recent presidential campaign, Republicans tried to lay the blame of the sub-prime mess on the Carter and Clinton administrations. Democrats tried to lay the same blame on the current Bush administration. Aubry & Eustice believes that all politicians, regardless of party affiliation, should shoulder blame.

Another group of people who should also share the blame are some of the American people who purchased homes they could not afford to live in. Yes, it is the American dream to better oneself with the freedoms this country affords, but there are consequences to poorly made financial decisions. Bad financial decisions almost always yield bad results.

As the finger of blame continues to point, let us not forget another contributing factor to this situation we’ve found ourselves in. Greed. The greed displayed by banks, lenders and mortgage companies essentially built a “house of cards” that was destined to crumble. When faced with the option of following logic or following the money, all too often greed wins out.

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While politics, personal desires and greed are contributing factors, it is also Wall Street that shoulders blame for the current financial and credit malaise. However, it is not simply “Wall Street greed” that our politicians have been complaining about over the course of the last eight or nine months. Both *greed* and *fear* are primary motivators in capital economies and investing. However, we contend that it was Wall Street’s fear, rather than greed, that also led to the current situation.

Here is what we mean: it is now well-known that what has contributed most to the current financial malaise is the securitization of sub-prime loans. These sub-prime loans were packaged together and sold as investments. As any business in a society based in capitalism, the people that work for Wall Street firms are always trying to figure out how to improve revenues. In doing so, new “products” are created. There are great opportunities in a capitalist society to take bad “products” and sell them to someone else for a profit. Consider what eBay allows its members do. (More on eBay later.)

Since the 1990s, and exacerbated by the increase in use of the internet and internet-based platforms, Wall Street firms have been losing their dominance in dispensing “financial information.” This is because of the rise of independent financial firms and, therefore, increased competition. Because of the increased competition, margins (or profits) are decreased for the larger firms. Competition drives prices down for the consumers. For example, as late as 2001, the larger firms were charging upwards of \$75 to \$100 just to buy or sell a stock through a “broker.” Now, because of independent firms *and* competition, it is possible to buy or sell stocks for \$3 on the internet.

To offset these shrinking margins, Wall Street has to come up with new “products” every year to try to increase their revenues. In this situation, the new “product” was the bundling of mortgages. Most of the mortgages are good and are being paid. The problem is that some of the mortgages are bad and are not getting paid by the borrower. This number is a relatively small number, but large enough to cause concern because they are lumped in with all of the other good mortgages.

Regardless of what the politicians are currently screaming about, big, new, sweeping reform and regulation is not needed. What is *needed* is transparency. There is transparency in the stock, bond, oil, corn, bean and frozen orange juice markets (and just about every other market that you can think of; we wrote about this in our October 7, 2008 blog post *Stolen Milk, Free Milk or Clean Milk*, <http://aubryeustice.com/blog/?p=25>). But because of the relatively new “mortgage products,” there is no market, and since there is no market, there is no transparency.

It is a basic economic principal that *capital flows to where the expected return is the greatest*. Investors will purchase almost anything that they think will make them a profit or has value. It can be argued that human beings will buy anything they think has a value. It is amazing how many items are bought and sold on eBay that would be seen by most as junk. But as the saying goes, “one person’s garbage is another’s gold.” The same is true for investing.

One of the many great advantages of capitalism is that people are able to have an exchange of items as long as a value can be agreed to (early forms of capitalism helped us decide that my two cows were worth your four pigs).

The greatest benefit that eBay has provided to society is *transparency* to the sale of “junk.” One of the most important fixes that can be employed to end this financial malaise is to allow for the creation of a market that offers transparency to “mortgage products.”

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Markets and exchanges are regulated, first by the participants. If there is transparency, investors know what problems will potentially come if they purchase a particular product. Once a market is created, it is then the role of the Securities and Exchange Commission (SEC) to make sure everything is fair.

This is actually one of the many areas that the Treasury Department has been working on. One of the biggest roles that the Treasury Department is playing right now is to help establish a market for the “mortgage products” that provides for the needed transparency. Once investors know what they are getting, prices can be accurately set based upon the perceived values of the buyers and sellers; specifically, the laws of supply and demand.

While very few Americans were completely supportive of the most-recent “bail out,” it is important that we let it work and create the needed market and desired transparency. We must now encourage the politicians to quit thinking they can solve everything with legislation and stay out of the way.

The Aubry & Eustice Portfolios

Aubry & Eustice has two types of portfolios: *Standard* and *International*.

The Standard portfolios have 50% of the investments inside of the United States and 50% outside of the United States. The 50% outside of the United States is split evenly between “developed” markets (i.e. the UK, France, Hong Kong, Spain, Japan, Australia, etc.) and “emerging” markets (i.e. India, South Korea, the Philippines, China, Brazil, etc.).

The International portfolios have 25% owning investments inside of the United States and 75% outside of the United States. The 75% outside of the United States is split evenly between “developed” markets (i.e. the UK, France, Hong Kong, Spain, Japan, Australia, etc.) and “emerging” markets (i.e. India, South Korea, the Philippines, China, Brazil, etc.).

Most investors use the S&P 500 as their main benchmark. International investors (those outside of the United States) use the MSCI EAFE index as the main benchmark. Investors investing in emerging markets use the MSCI Emerging Markets index to compare the performance of investments made in emerging markets. Because of the dramatic diversification offered by the Aubry & Eustice portfolios, we do not believe it fair to clients to use just one benchmark. Therefore, we have created our own benchmarks; the A&E Standard Benchmark and the A&E International Benchmark (very creative names, huh?)

Both benchmarks use the S&P 500, the MSCI EAFE and the MSCI Emerging Markets indices in the same proportion as the Aubry & Eustice portfolios use the US, “developed” international markets and “emerging” markets. From now on, when reporting returns, we will show the S&P 500, the MSCI EAFE, the MSCI Emerging Markets, the A&E Standard benchmark and the A&E International benchmark.

No one wants to see the values in their account decrease. However, with as much exposure to “developed” international and “emerging” markets as the Aubry & Eustice portfolios have, we are very pleased with the relative performance of our strategies—especially the annualized returns over the last 10 years.

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Performance (as of September 30, 2008)

	YTD	1 Year	10 Year
S&P 500	-24.85%	-21.98%	3.06%*
MSCI EAFE Index	-36.55%	-30.13%	5.42%*
MSCI Emerging Markets Index	-44.12%	-33.01%	14.77%*
A&E Standard Benchmark	-32.79%	-26.62%	6.74%*
A&E International Benchmark	-36.62%	-29.01%	8.51%*
Standard 97	-29.98%	-26.51%	12.07%*
Standard 88	-27.16%	-23.94%	11.42%*
Standard 75	-23.44%	-20.44%	10.47%*
Standard 50	-15.47%	-13.13%	8.50%*
Standard 25	-6.97%	-5.37%	6.33%*
International 97	-35.04%	-29.70%	13.57%*
International 88	-31.91%	-26.90%	12.80%*
International 75	-27.44%	-22.93%	11.69%*
International 50	-18.49%	-14.99%	9.40%*

*Denotes annualized return.

Disclosures

Performance data shown 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 return 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. As with any investment strategy, there is a potential for profit as well as the possibility for loss. The investment strategies used by Aubry & Eustice, LLC are based on the hybridization of the Modern Portfolio Theory, the Efficient Market Hypothesis and the French/Fama Three-Factor Model. These strategies constitute Structured Asset Management with an emphasis on diversity in order to reduce risk.

The Aubry & Eustice, LLC portfolios are designed based on statistically relevant historical performance data for broad asset classes. These portfolios represent assets to be invested and allocated in numerous asset classes as determined by academic and scientific research. The data shown represents model portfolios constructed by Aubry & Eustice, LLC utilizing mutual funds. However, specific investor objectives and situations may warrant the utilization of alternative investments due to issues of taxability, or cost associated with diversification, and/or for other reasons as determined by Aubry & Eustice, LLC. The performance information presented in these charts, graphs and tables represent the average annual and/or average monthly returns for specific model portfolios. Data prior to July of 2005 represents back-tested performance figures for each portfolio based on actual mutual fund data. The back-tested and model performance figures assume the reinvestment of dividends and capital gains.

The performance shown is "gross performance," which includes the reinvestment of dividends and other earnings but does not reflect the deduction of investment advisor's fees and other expenses. A client's investment returns will be reduced by the advisory fees and other expenses it may incur in the management of its advisory account. The advisory fees can be obtained by contacting Aubry & Eustice, LLC. Aubry & Eustice, LLC is not paid any form of compensation or commission from any mutual fund company or broker-dealer. Therefore, our selection and use of underlying assets is based solely on that asset's ability to best meet client objectives. Back testing and model performances have certain limitations and do not reflect an actual individual client's performance. Actual client accounts may vary significantly from the model performances due to factors unique to each client. The performance figures do not take into consideration significant economic or market conditions, rebalancing costs, cash flows, actual trading and transaction costs, all of which, when deducted, would reduce returns. For all data periods, performance figures and standard deviations calculated by utilizing information provided by Dimensional Fund Advisors, Standard & Poor's Index Services, Morningstar, the CRSP database, the MSCI database and other internet-based securities databases. All indices have certain limitations.

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