



Joseph M. "Jette" Browne, CFP®

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421 Third Street North
Jacksonville Beach, Florida
32250

Office 904.241.5121

Toll Free 877.EAGLE04
324.5304

Fax 904.212.0193

www.eaglewealthmgt.com

Investors Challenged in 2007

As 2007 draws to a close, we can look back on a very challenging year as investors.

During the first half of the year, euphoria reigned in the markets based largely on speculation about mergers and acquisitions (M & A) strategies. It seemed every Monday a new and larger merger or acquisition was announced. If you owned stock in a company to be acquired, you'd see an immediate windfall jump in the stock price. If you owned stock in the company doing the acquiring, you'd usually see an immediate drop in the stock price. So there was lots of analysis around touting which firms would be the most likely next acquisition targets. Hedge funds and other institutional investors were pouring money into the market chasing these M & A expectations and the market indices ran up nicely. Meanwhile, the ominous matter of a collapsing residential real estate market went largely ignored. Besides, the party was going so well and the wine was so very fine.

Finally in late July the black horsemen of sub prime mortgages crashed into the party and the revelers were cut down on the dance floor. The principal victims were the large investment banks like Citigroup, UBS, and Merrill Lynch. In the last few months, tens of billions of dollars have been recognized as lost by these firms and there may be more bad news to come. Not only have their own stock prices been hammered, but their ability to lend, which was critical to the speculative strategies in the hedge funds, has been badly curtailed. The end result has been a pull back in the equity markets over the past four or five months and a large dose of worry in the markets going forward.

A couple of particularly unusual events occurred recently when Bank of America and General Electric were forced to shut down two of their "enhanced" money market funds. The term "enhanced" should always raise a red flag. One of the iron laws of investing is that if you find a way to enhance the returns on an investment, somehow you have also managed to enhance the risks as well. The enhancements in these cases were short-term loans backed by credit derivatives on mortgage-backed securities. When investors tried to pull money out of these funds, the funds found they couldn't resell the mortgage-backed securities and the funds essentially blew up. Fortunately these funds were only available to institutional investors investing a minimum of \$25 million in the funds so no private individuals were directly exposed. Nonetheless, I revisited the prospectus for the T.D. Ameritrade Money Market Fund, which was the sweep account for cash in all of our investment accounts. I found that indeed, this fund was allowed to invest in mortgage-backed securities, so I have moved all the cash allocations in our accounts into the T.D. Ameritrade Government Fund where the investments are either issued by or guaranteed by the U.S. Government. The small reduction in yield of about two tenths of a percent per year appears a small price to pay for the additional level of safety in the current market environment.

Real estate speculators are unusually quiet right now, too. There's been a major rediscovery of risk in direct real estate investments. The Condo market in our area has virtually collapsed. Within a 10 minute walk of my office in Jacksonville Beach there are a dozen high end condo projects, with units priced in the six and seven figures, that have been masquerading as vacant lots now for almost two years with faded signs, torn and flapping in the ocean breezes. Several nearby condo projects, which have completed construction in the last year or so, remain only partially occupied and are surrounded by for sale and for rent signs.

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*“Even if you're
on the right
track, you'll get
run over if you
just sit there.”*

Will Rogers
(1879-1935)



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more from Will Rogers...

*“Don't gamble;
take all your
savings and
buy some good
stock and hold
it till it goes up,
then sell it.
If it don't go up,
don't buy it.”*

Well, what's the good news? Bonds, especially U.S. Treasury bonds and highly rated municipal bonds, those boring investments many folks wouldn't touch, have performed very well in this environment. Once again, the value of balance in your asset allocation has been rewarded. Actually, I think boring is not all that bad for serious money upon which you depend now or may in the future depend on to supplement your retirement income sources. I believe if someone needs excitement with money, then a short trip to Las Vegas works pretty well.

This is not to say that we should avoid the equity markets altogether. There will always be some stocks that perform well, even in the most challenging of markets. Even with careful diligence in the selection process, finding the solid performers will always involve some degree of trial and error. When we get it right, we want to get the best ride we can. When we get it wrong, we must cut our losses quickly. This has always been a key to making money in this business.

I think it may have been Will Rogers who said "forecasting is always foolish, especially if it's about the future." In 2007, I expected the weak real estate market to force a pull back in the stock market fairly early in the year. I was frankly fooled by the strength and momentum of the bull market that ran into July. So I won't try to give you a forecast for 2008. My priority goal for the coming year, however, remains to help my clients achieve their financial goals with an emphasis on preservation of their capital. Accordingly, unless you've told me you desire to take on a more risky posture, you can expect a prudent approach including a cushion of cash, which also provides dry powder for emerging opportunities, and a balanced mixture of asset classes in your portfolio. With all the forces currently in play, 2008 may well be a year when a net return in the single digits will be a very successful strategy.

I want to thank all of my clients for the opportunity to serve them this year and wish everyone a happy, healthy and prosperous 2008.

Warm Regards

Jette