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What to Do Now?

One thing is certain- no one has ever been here before.

The Government is taking over major institutions which are not failing and keeping the money. It is making huge loans to aid the international markets survive the counterparty risk brought on by some really large institutions gambling with each other.

In the past 9 months we have gone from 5 independent investment banks on Wall Street to none, with two going out of business, two converting to banks (horrors!) and one being taken over by a bank.

We think the following things are afoot:

DE-LEVERAGING

Our society and especially our institutions are de-leveraging, that is they are selling assets and trying to reduce the debt they have, and this has caused:

1) The price of a lot of mortgage backed securities are terrible, as everyone wants to sell- no one wants to buy and those that might want to sell or buy can't agree on a price. Clearly the buyers will make a lot of money if they can hold, and the sellers are getting more desperate- this is why the government needs to help get the process going faster by the famous $700 billion rescue package

2) Banks do not trust each other. No wonder why, with over a trillion dollars at banks here and abroad changing hands just yesterday, which we believe that's double the saving and loan mess in one day. And that was a slow day compared to some we have seen.

3) This is causing weird fluctuations in short term markets with our Fed making short term loans to other central banks and via open market transactions trying to keep the engine going when it is about out of oil. It may not seem scary when at dinner you hear that the LIBOR rate is far above the discount rate, but it is scary to those that understand that it means that banks just are not loaning money or securities to each other and where that might lead the world economy.

LACK OF TRUST

It's difficult to trust the Government, Financial Institutions or our elected officials. They appear to, at least on the surface, be downright stupid or completely out of touch or control.

Paulson: Give me a Bazooka and I won't have to use it (He used it)

WaMu: We are well capitalized! (They are now owned by JP Morgan Chase).

Wachovia: We only have $10 billion in toxic assets (They got rescued by Wells Fargo Co. in a manner which indicates that they might have upwards of $40+ billion in toxic assets)

AIG: We need $10 billion, no $20 Billion, a few days later, make that $85 billion

and lots of others....

HOUSING AND CONSUMER DEBT

The housing market looks like it's still a mess although, a year into this maybe we have seen our worst. What we don't know is what the current credit crunch (commercial paper revolving loans, money markets, international banking relations etc) will have on the real estate markets.

THE GOOD NEWS:

Oil Prices are way off their highs

Interest Rates are low

Time is going by, we need that to recover and lick out wounds

Foreigners seem to still be investing in the US, the dollar has not rallied that much, China is still growing although a lot less than before, their own consumerism has to be good for the world and hence us

Our Government (I won't mention Congress as I write this one day after they decided to play Russian roulette with the world's banking system) but our government (Treasury, the Fed, the FDIC) seem to be all over the problem that may help

The government "took over" Fannie Mae and Freddie Mac, although they were "well capitalized" a few days before, this means that there will be a place for your local bank or mortgage broker to sell your next mortgage that is very good.

Corporations have a lot cash, generally most public companies are not in trouble, inventory levels and debt levels are lower that are typical in times like this

Buffett is buying! (Hello!)

HERE IS WHAT WE THINK ARE THE MOST ADVISABLE THINGS TO DO

As I started this, I said we have never been here before; no one has, while a bad market and a crisis situation is nothing new; this situation is the perfect storm of housing collapse, mortgage fraud and over leverage, rating agencies running amuck, and financial institutions gambling like drunken sailors or worse, mixed in with new and very exotic and powerful derivatives that threaten all of us.

We think that there are great bargains out there, perhaps the market as a whole, is a bargain. We also think the economy will not likely rebound very quickly, the whole mess is so far reaching and at so many different levels that when stability returns, (meaning the de-leveraging is nearly complete) it will take time before "trust" returns.

From our point of view, we would like to stop having "Breakfast with Hank" which is what we in this crazy business call the Sunday vigil we have been through the past weeks looking waiting and watching who the Treasury secretary Hank Paulson will "deal with" on Sunday. We would like to see him not need to take action each Sunday.

A long vacation is in order for him and his staff. But not right away they still have work to do in properly administering the "Bailout of America" $700 Billion program.

We think we will recover and that it will take a while, and want to factor that conclusion into how we want to invest. As follows.

Step 1:

We want to get out of the way of the storm, when we know where it's going. But not do so foolishly. While a couple of the stocks we own (formerly some of the most conservative on the street) have lost a lot of value we need to be there when the upside comes. This is a case by case basis, and is not easy, due to the apparent "fibbing" that is Going on.

Step 2:

Buy things that have suffered during this mess. All the great investors tell us that buying in down markets is when you make the most money.

"Buy when there is blood in the streets", - Templeton
"Be greedy when others are scared- scared when other are greedy"- Buffett

Step 3

Diversify.

We want to buy more different companies than normal. This is because event risk, is very real these days. While there is less risk in the markets these days (because the prices are lower) there is still risk in there. We want to diversify more than usual.

Step 4

Buy Stocks that generate income-pay dividends.

Reasons for this:

a) Companies that are paying dividends in today's markets hopefully see themselves as profitable now or in the very short term, We want that.

b) If things get worse for them they can reduce the dividend that might give them more resources to deal with the issue they face, generally we are considering the dividends as being fat, when food gets scarce, these companies have some fat to live off of.

c) Given the lack of trust and the de-levering that is going on, it may be a while before the indexes start setting new highs, those dividends may be our return for the next year or so.

Step 5

Make our time horizon 2 years or more- not a couple of minutes. The news media is never our friend. In markets like this it's our enemy. Emotion will kill portfolios.

We see the portfolio of these stocks being composed of 4 categories:

Energy: Energy is going to be a focus as the world moves forward, as we can buy energy stocks that pay us large dividends we want to take advantage of that.

Financials: We know they have been beaten up, but a few are out there that look to be survivors and more big winners. There is risk everywhere, but the potential reward offered by these stocks is extreme.

Big Pharma's: These companies are down a bunch, some at multi year lows while we are getting older and taking more drugs.

Real Estate Investment Trusts: These generally income producing stocks owns and operate real estate.

These 4 categories are included because:

1) Those that pay dividends could reduce those dividends should the situation get worse and hence might provide a bumper that might help the companies survive.

2) Should the economic situation improve, stress, fears come off and so forth, the more conservative investors might start looking for value here seeking more safety in the high dividends

3) If the markets and economy level off with no further worsening or great improvement the dividends, should they be continued, might be our return on the investment. Further, they might be tax advantaged.

4) It's likely that the hangover from the cocktails that the world's central banks and governments are using to fix this mess will leave us, with a recession and/or possibly high inflation. Some of these sectors own assets that might appreciate in an inflationary cycle.

5) These stocks are down in value due to fears of stress and the risks that the situation poses to their businesses. Hence from an historical sense as the prices are down, there is less risk in the investment

Of course, dividends can change and can be eliminated and in this particular situation high dividends don't necessarily mean that, in the recent past the company is generating enough earnings or cash flow to support them. These are fast moving times.

This is the direction we want to move in.

Thanks for your trust and confidence....

Charlie, John and Crew at the "Breakfast with Hank" Coffee shop

Past Performance is no guarantee of future results. Representatives of Mutual Service Corporation do not offer tax advice. Consult your tax professional for all tax matters.