

09/30/2008 Quarterly Newsletter

Discipline is the key to success

With every approach to the stock market, bear in mind that there will always be periods of over-performance and periods of under-performance. Here at Disciplined Wealth Management (DWM), our goal is to concentrate your portfolio in the leading asset classes while avoiding the performance-sapping lagging asset classes; over the long term, our approach strives to provide you with better performance compared to the overall stock market average (the S&P 500) and with less risk. In summary – stay disciplined during times of under-performance; don't become emotional and abandon a proven long-term strategy during a usually short period of under-performance, but stick with it and let the strategy work for you. If someone says they are never wrong, they have just proven themselves otherwise.

General commentary –

The last 20 years have been an era of expanding leverage. Is it over?

In short, following an extended period of leverage-driven growth in the U.S. Think for a moment about how a mechanical lever like a see-saw or a teeter-totter works. A see-saw pivots in the middle and is used to move a person up by a force applied at the other end. Have you ever attempted to lift a child who is sitting alone on a see-saw by lifting the end he or she is occupying? It's not easy, regardless of the weight of the child. But if you use the lever and sit down on the unoccupied end of the see-saw, you can lift the child into the air with almost no effort at all. This analogy fits the U.S. economy between 2003 and 2007, as banks were more than willing to play with you on the see-saw and provide the leverage to lift you higher than you wanted to go.

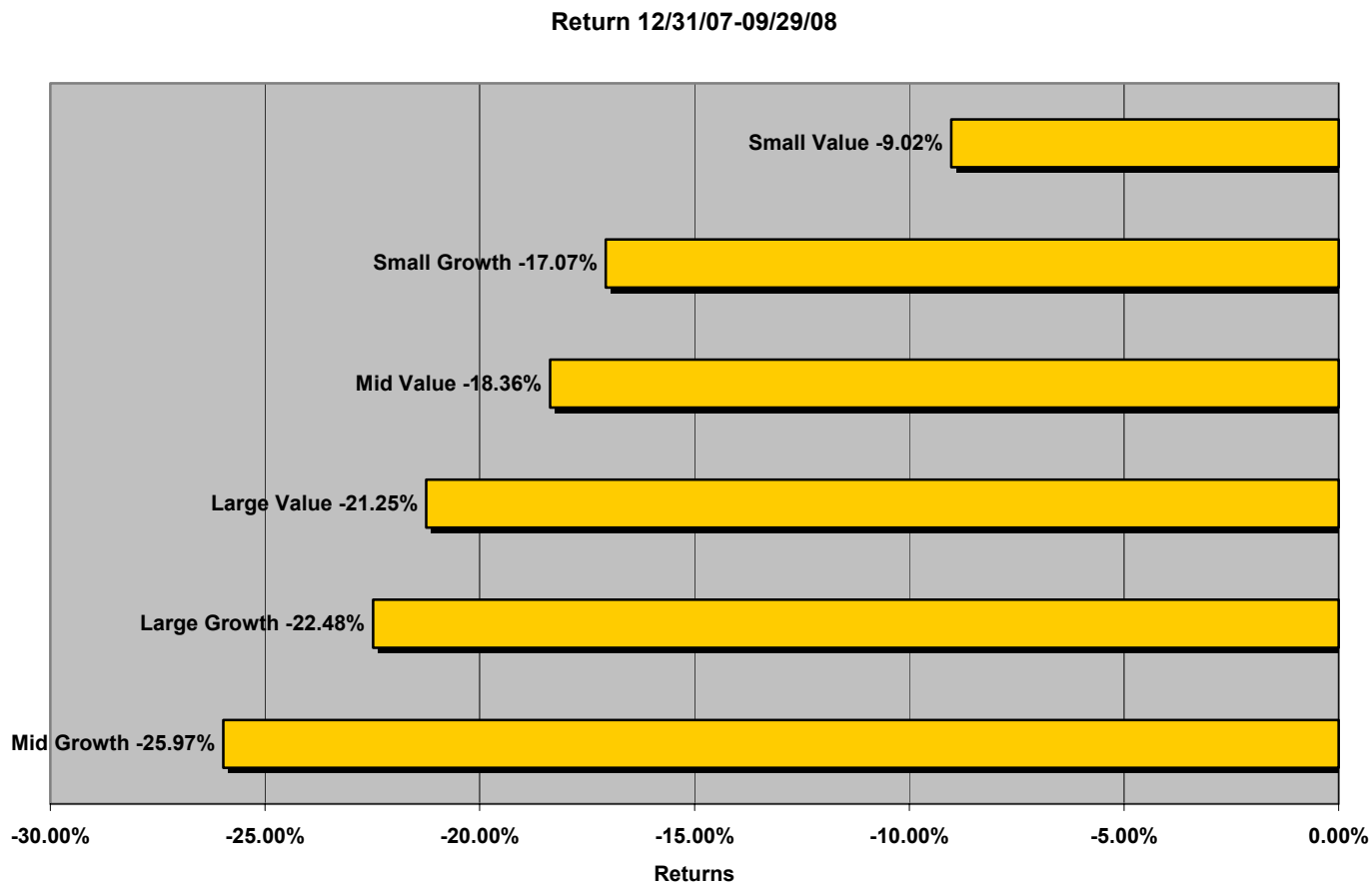
The nation has now embarked on a de-leveraging process that is likely to keep economic growth muted for quite a while. An old adage says that a bank may lend you an umbrella when it is sunny but will take it back as soon as it starts to rain. In other words, banks are climbing off the see-saw, making it harder for the consumer to rise. The credit crisis is playing out in three stages, beginning with the hit to the loan originators that is now near completion, and moving to the financial markets that may begin to form a bottom. The final stage or the “real crisis” (effects on the real economy) is likely to continue through 2009. Unfortunately, the slump to the real economy has only just begun.

Key credit market indicators continue to flash extreme warning conditions. Conditions continue to tighten as banks struggle to rebuild their balance sheets and maintain their solvency, while U.S. households, faced with an overwhelming array of headwinds, are losing their appetite for debt. So the answer to the question of whether the era of expanding leverage is over could very well be a definite “Yes.”

As we go to press, the overall market environment indicator remains Bearish. We will continue to monitor this indicator and make the necessary adjustments.

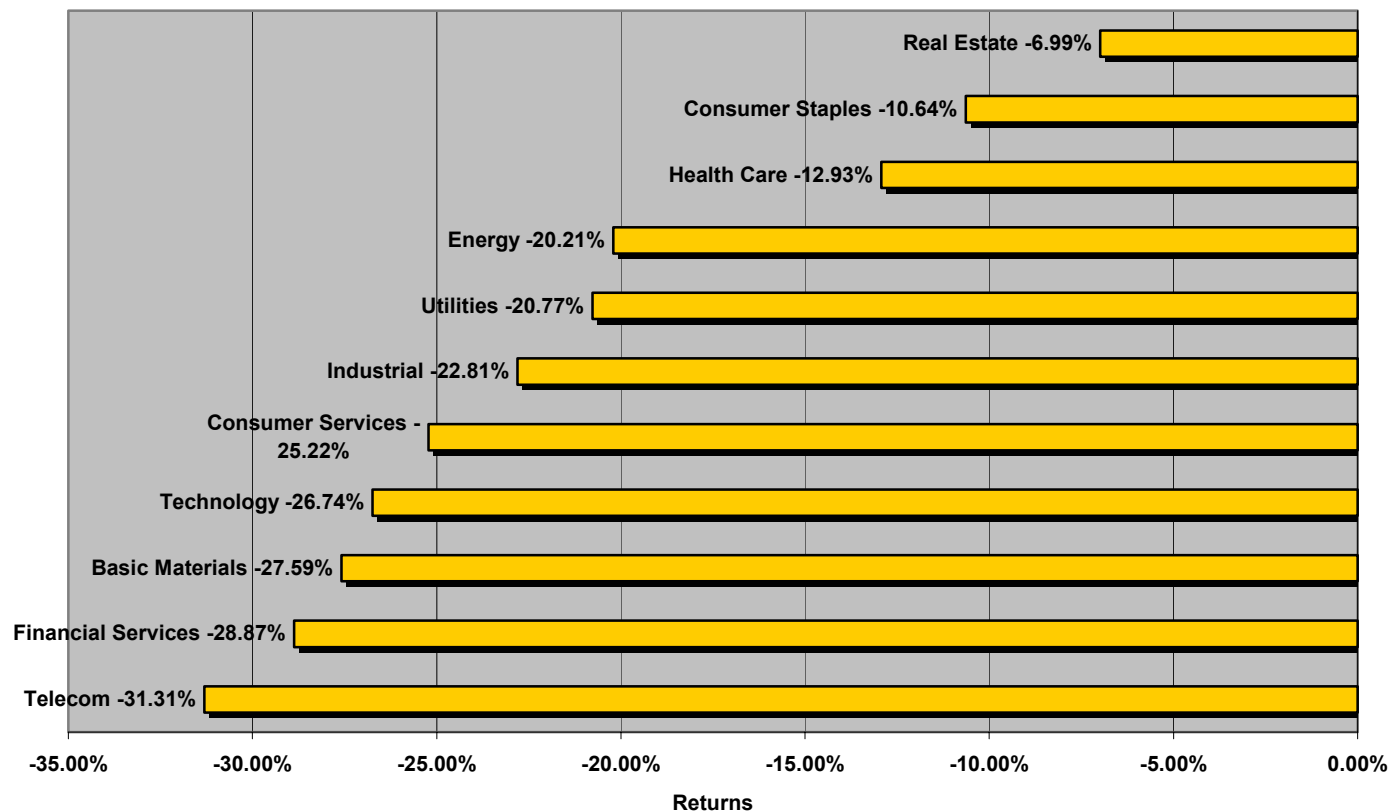
Please note that, in the following pages, the performance charts for certain asset classes are for illustrative purposes only, and do not reflect the ranking system utilized by DWM.

Style boxes – Even in an ugly stock market, bigger isn't always better. In hopes of weathering this year's stock-market storm, many investors have gone on the defensive by buying shares of large companies. They figure the size and global scope of these businesses promise greater stock-market stability than shares of smaller companies. But while that strategy has paid off in some previous down markets, it's not doing so in 2008: So far this year, small stocks have notably fallen less than their large brethren. And over the past couple of months, small stocks have posted an even greater "rally back than the rest of the list," says Phil Roth, chief technical strategist at Miller Tabak, a trading firm for institutional investors. This supports my relative strength work, which continues to favor Small Caps, be it Value or Growth, as they continue to be two of the strongest styles in my ranks. As usual, we will continue to rely upon our time-tested relative-strength analysis to guide our investments in Style Boxes.



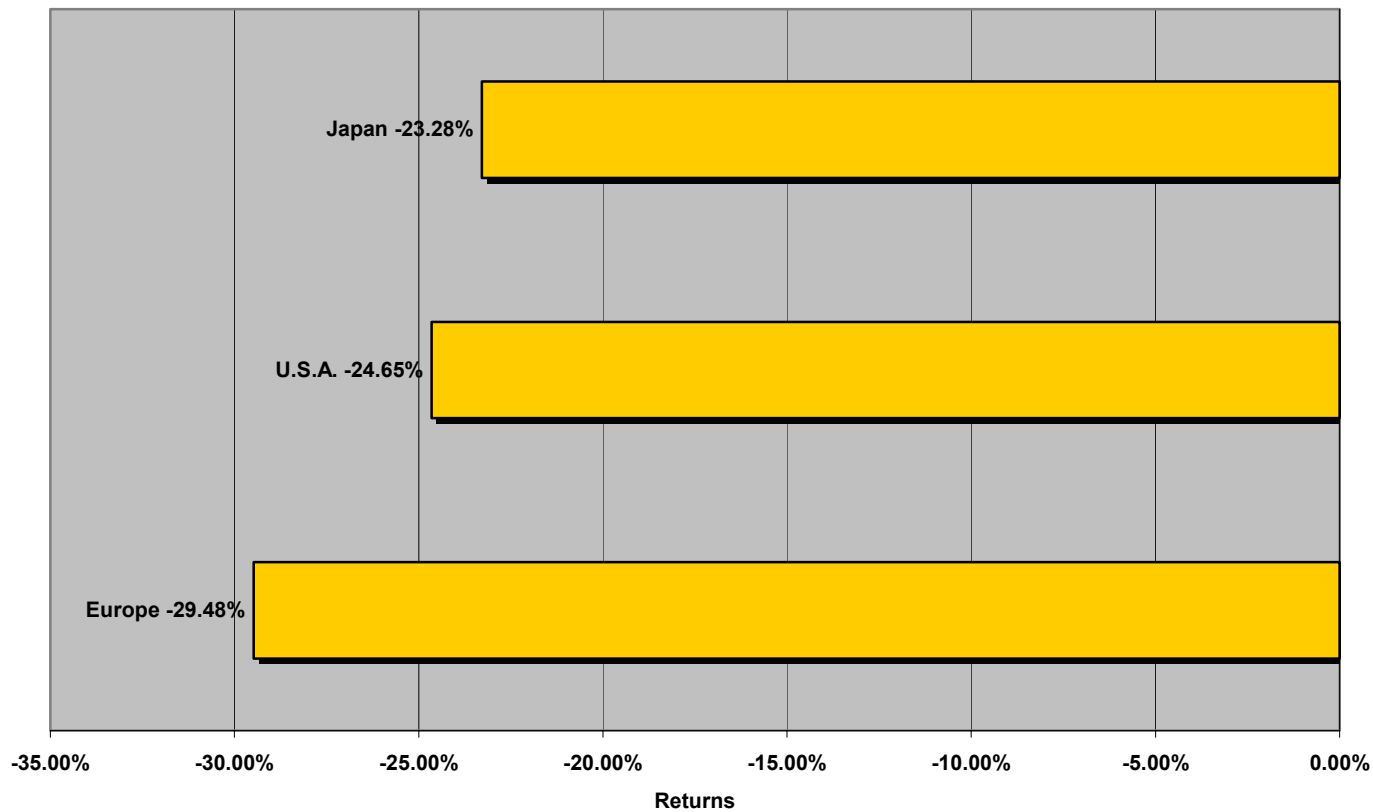
Sectors – It should come as no surprise that Financial Services was the only sector with no movement in my relative strength work as it continues to bottom feed as the weakest sector. However, at some point, the financials will touch bottom and start to work their way up in my work, but it did not happen last quarter. As measured by the I-shares Financial Services ETF (IYF), the sector lost over 18% for six months ending 9/29/2008. These losses were consistent across all sub-sectors as banks, brokerage, and insurance stocks all suffered. Reports continued to suggest that losses in subprime mortgage securities will continue to mount. At the opposite end of my Relative Strength work, Health Care and Consumer Staples had the largest move up, as both sectors jumped five spots to claim the top two positions in my ranks. As usual, we will continue to rely upon our time-tested relative-strength analysis to guide our investments in Sectors.

Return 12/31/07-09/29/08



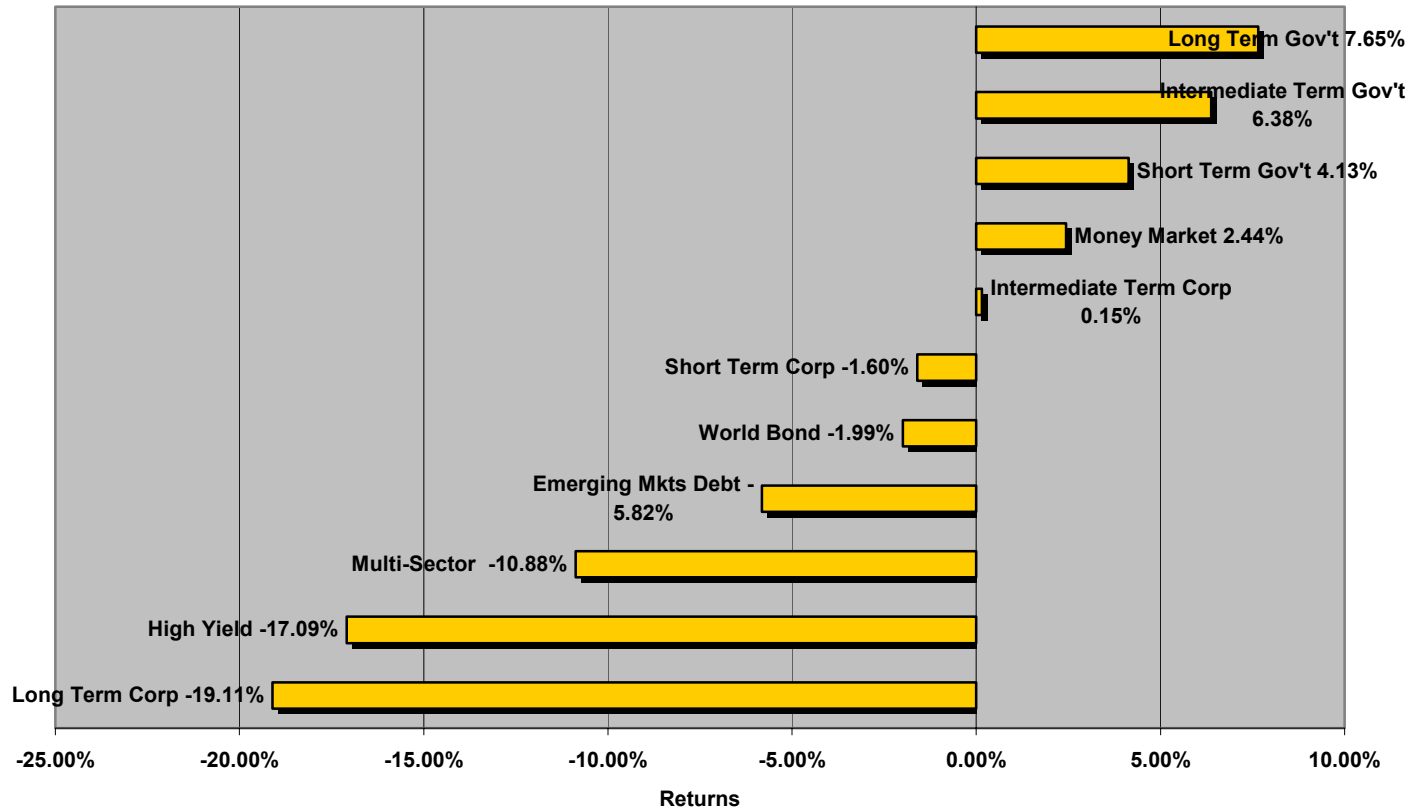
Internationals – Hopes that the rest of the world could safely ignore a U.S. economic slowdown were dashed in the 3rd quarter, as virtually every market declined, even when measured in local currencies. In dollar terms, several previously thriving emerging markets led the way down, particularly India. The I-path MSCI India Index ETN (INP) dropped -37% for six months ending 9/29/2008, while Brazil also showed a loss, but fared much better than their Indian colleagues. This may be because Brazil is a commodity exporter, while India is a major commodity consumer. As usual, we will continue to rely upon our time-tested relative-strength analysis to guide our international investments.

Return 12/31/07-09/29/08



Bonds – Cash is king!!! The first large money market to break a buck is causing a lot of concern and telephone calls by the holders of \$3.5 trillion in money markets. The Reserve Primary Fund, one of the nation’s oldest with \$62.6 billion in assets, wrote off \$785 million in Lehman Brothers paper causing the NAV to drop to \$.97. Not a huge loss, but enough to get the big boys, Fidelity, Vanguard, Wells Fargo, and Schwab to reassure investors that they do not hold any Lehman paper and their money market funds are solid. As usual, we will continue to rely upon our time-tested relative-strength analysis to guide our bond investments.

Return 12/31/07-09/29/08



Forecast –

Did the Market reach Capitulation?

Many times market bottoms are identified by manic capitulation: frantic, panicky, and emotional selling by investors and institutions. Fear overtakes common sense, and they end up abandoning all hope, typically near or at the bottom, and typically, a disastrous move. And volatility is almost reaching a point of insanity: consider this: during the week ending 9/19/2008, the cumulative move in the Dow was a whopping 2000 points, 20% of the index!

We saw several signs that this was occurring during the week ending 9/19/2008:

- Both Monday and Wednesday, the number of stocks going down versus going up was 14 to 1, and 19 to 1. I believe at the 2002 bottom the number only got to 10 to 1—a good sign that people are panicking and selling just about everything.
- That week we had four 9 to 1 down volume to up volume days (extremely lopsided) followed by a 10 to 1 up day.
- Gold, considered by many a safe haven during turmoil (we should mention that we do not), jumped over \$80 an ounce, setting a one day record price gain! Keep in mind that this “safe haven,” before the jump, was down over -20% from its recent peak.
- Bankruptcies by major names, while emotionally distressing, always occur near the bottoms. It happened in the bear market of 2002, 1987, and the ‘70’s. The excesses of the previous bull market are being cleansed, in a sense.

A couple of things to keep in mind—first, it is almost impossible to pick bottoms or tops. The better strategy is to stick with broad based indicators that will tell you if the market is healthy or weak. You will never buy at the exact bottom or sell at the exact top, but your goal is to avoid 80% of the decline and participate in 80% of the advance. Even though this is difficult, it does lead to a smoother and wealthier ride.

This leads to a second point that, by following a time tested broad based signal, we reduced our exposure last November (only interrupted by a two week buy signal) and have avoided the vast majority of this decline. We are feeling very comfortable at this point; having avoided the majority of the pain. We are less likely to have the feelings of panic that are afflicting the vast majority of investors who have been following a buy and hold approach. These buy and hope investors are suffering great losses, and unfortunately, are the most likely to abandon their philosophy at the worst possible time.

The Market Environment Indicator remains bearish. Even if the week ending 9/19/2008 market action was a “cumulative market climax,” keep in mind that it is not uncommon for the market to do a quick retest of the old lows. If we get a retest, but avoid having another 9 to 1 down volume versus up volume, we may have seen the worst of this bear market and a sustainable rally could be in the cards for the 4th quarter.

Will this be the case? No one knows for sure and only time will tell. DWM, for one, will continue to rely upon its tactical tools to stay in line with the market’s fluctuations. Always remember: the key to investment success is to stay disciplined and flexible in an ever-changing market environment. The moment you start to second-guess your decisions is usually when you shouldn’t.

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Sources:

Style box data = Russell Indexes. Source: www.russell.com and Investors FastTrack.

Sector data = DJ US Sector Indexes via I-Shares. Source: Investors FastTrack.

International data = EuroTop 100 Index for Europe, Tokyo Nikkei Index for Japan, S&P 500 Index for U.S.A. Source: Investors FastTrack.

Bond data = Various bond mutual funds and exchange traded funds (ETF). Source: Investors FastTrack.