12/31/2008 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 Treasury's Troubled Asset Relief Program (TARP) is an attempt to recapitalize sound elements of the U.S. banking system and restore the impetus to sound, competitive lending. I would caution that historical evidence suggests that banking crises, recapitalizations, and the economic downturns that generally accompany them tend to take several quarters, sometimes years, to play out.

Banks are likely to face more write-downs in the coming months as economic conditions worsen, and the Treasury is likely to go back to Congress, hat in hand. That said, consider the beneficial effect that pumping capital into the banking system can have. If the government injects $250 billion, and banks lend using an even conservative 10:1 leverage ratio, the result would be the creation of an additional $2.5 trillion in the system. Representing around 17% of current nominal GDP, this amount could significantly help reinvigorate growth.

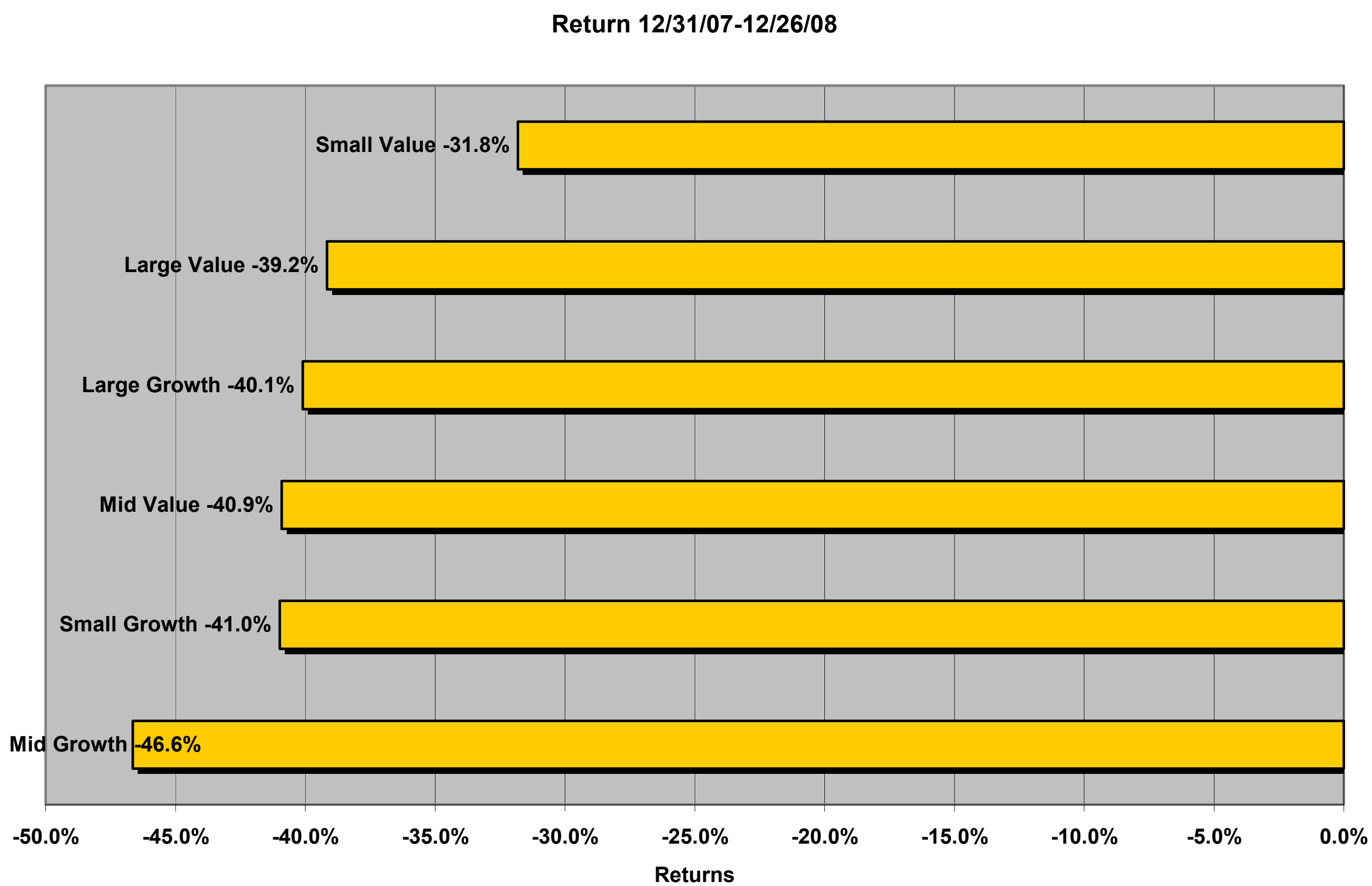
Of course I'm assuming that banks lend—and not hoard—the money. So far, not so good, according to the Fed quarterly survey of senior bank lending officers, banks' fists are at historic tightness, and lending activity is likely to be sluggish in the near-term as banks remain hunkered down. But good quality lending should recommence over time, particularly given today's attractive spread levels. As Alan Greenspan supposedly remarked in the early nineties, "At some point, bankers will start acting like bankers again."

As excerpted from "A New Era of Big Government?" by Dr. Jerry Webman

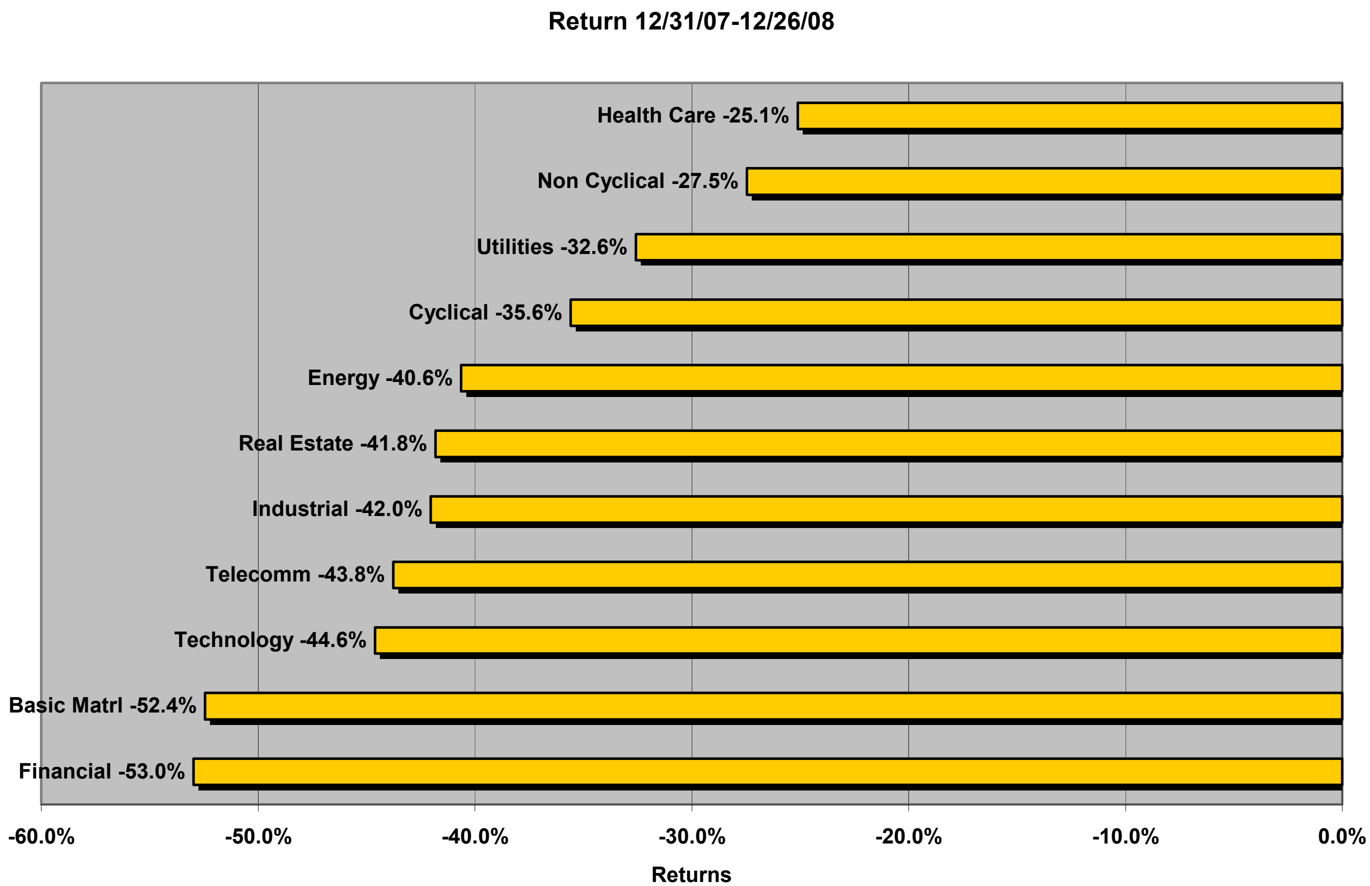
As we go to press, the overall market environment indicator remains Bearish. We will continue to monitor this indicator and make the necessary adjustments.

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.

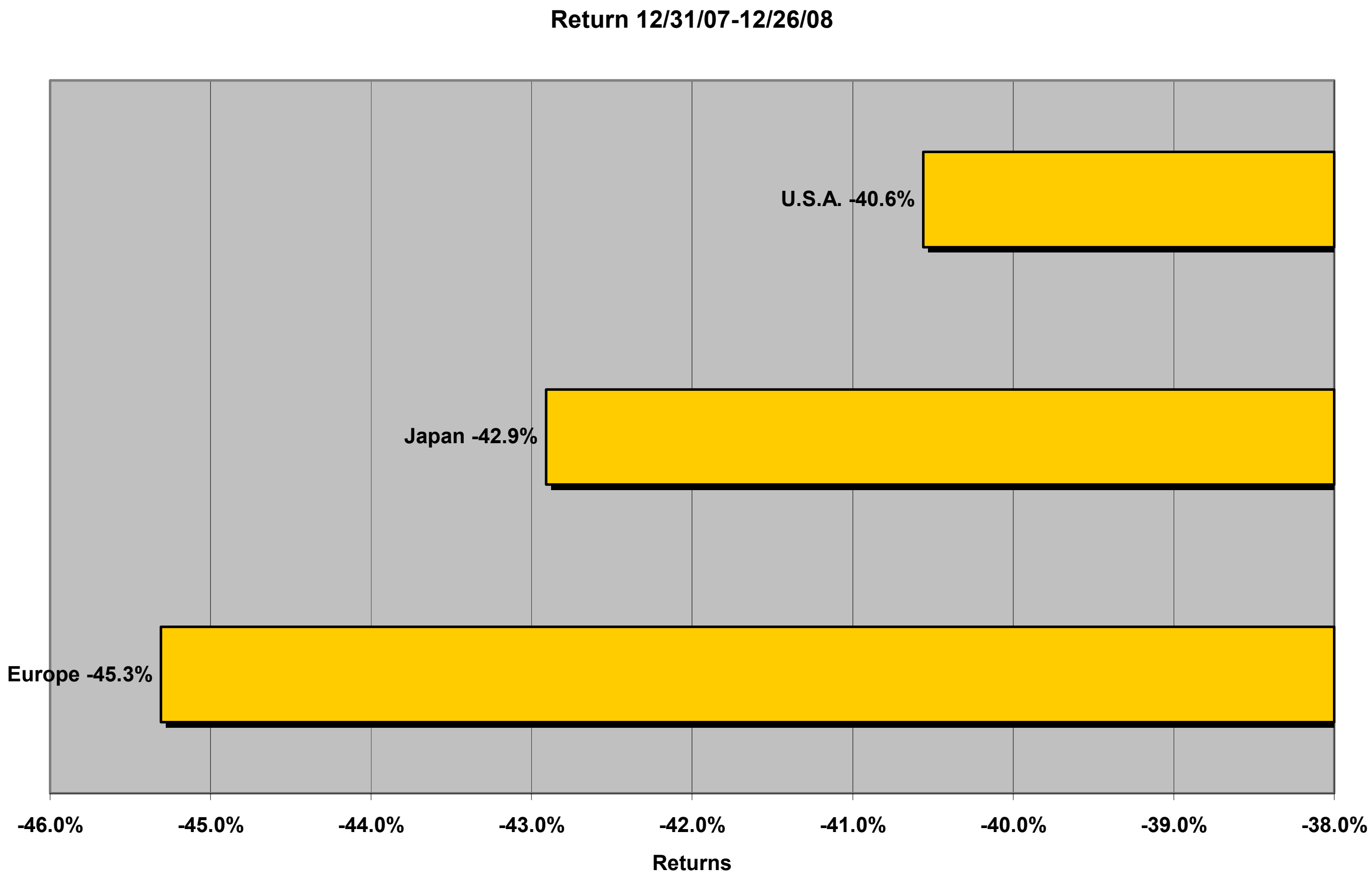
Style boxes – It was an ugly year across the board for all style boxes, as the chart below reflects. Keep in mind that one of the goals with my relative strength work is to focus on the leaders and avoid the laggards. This goal was accomplished last year. Small Value was the style with the most concentration, as Mid Growth was avoided for a majority of the year. Even with Small Value dropping more than 31%, it was a better place to focus than its counterpart, since Mid Growth was down over 46%. Small Value did 32% better than Mid Growth. Small Value continues to maintain its strong hold on the number one position in my relative strength work, while Mid Growth maintained its status as the weakest area. Large Value had the largest move upward in my ranks, jumping from the fifth position to the second. As usual, we will continue to rely upon our time-tested relative-strength analysis to guide our investments in Style Boxes.



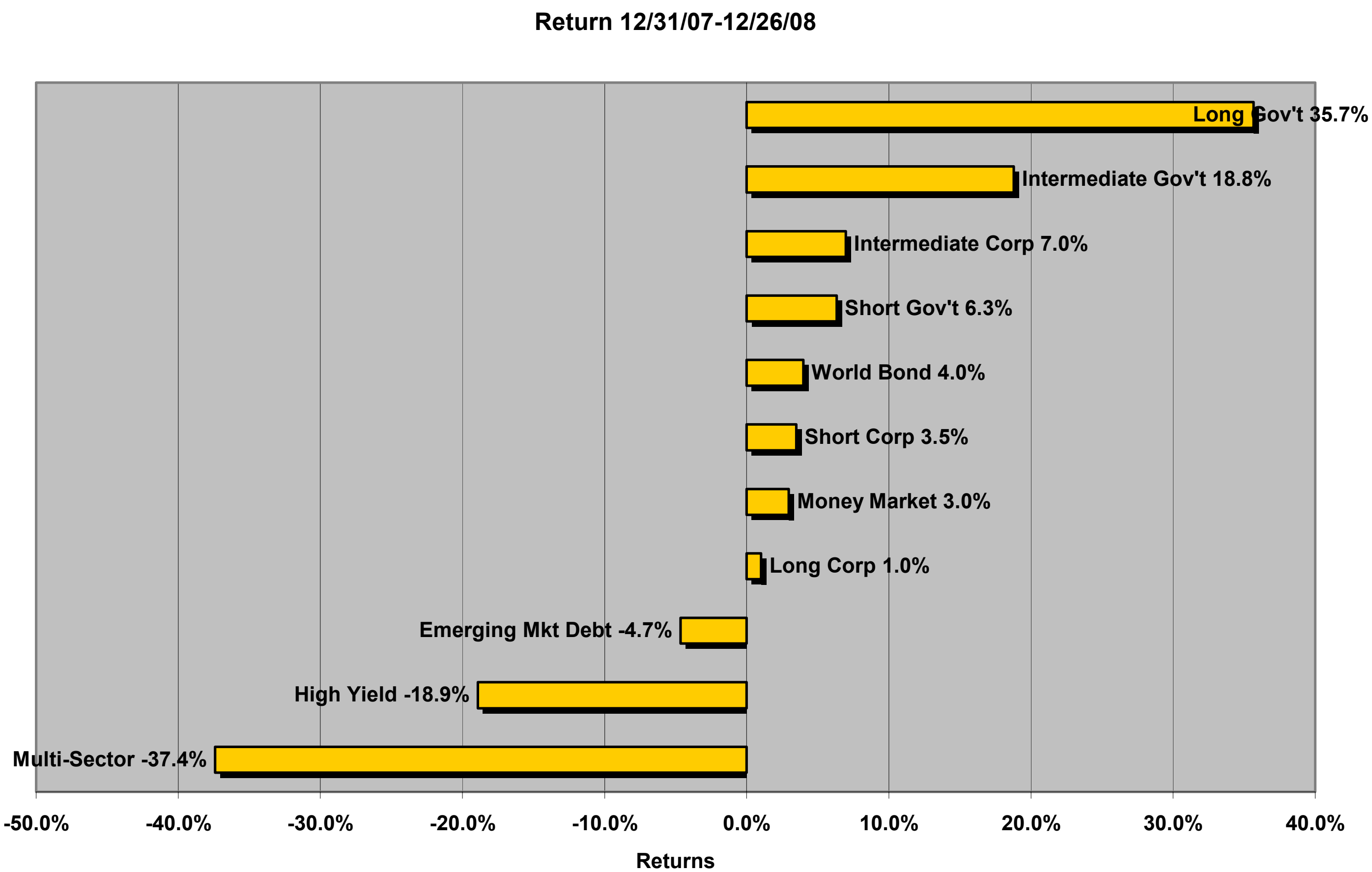
Sectors – What was said for style boxes holds true for sectors as well. It was an ugly year across the board for all sectors, as the chart below reflects. Because the Market Environment spent a majority of the year in bearish territory, sector funds were avoided as much as possible due to the increased volatility that follows these types of investments. Health Care continues its strong hold on the number one position in my ranks. Meanwhile, utilities and industrials had the largest move upward – both jumping four spots in my relative strength work. I feel that I don't need to touch on the financial sector, because we all know what happened there! Basic Materials was one of the shinning stars in 2007 and became one of this year's biggest losers, giving another great example of why you shouldn't fall in love with a story. Last year's darling can easily become this year's disaster. It's best to have a game plan in place before beginning the game, and, with DWM managing your account, you do. As usual, we will continue to rely upon our time-tested relative-strength analysis to guide our investments in Sectors.



Internationals – When the 2007 bear market began, Wall Street theory held that the U.S. suffered a unique sub-prime problem. Most of the rest of the world did not have a sub-prime problem and thus, with a global boom underway, the other countries could "decouple" from the U.S. and stay strong. A Ned Davis global study showed that almost all stock markets move together during bear markets, and that focusing on the sub-prime market was a mistake, because we had a much larger debt bubble and there was a global debt bubble as well. Emerging market growth has generally been slightly stronger than U.S. growth as the decoupling theory suggests, but, as can be seen on the chart below, the other two major countries were off every bit as much as the U.S.; every single country is in a bearish trend. As usual, we will continue to rely upon our time-tested relative-strength analysis to guide our international investments.



Bonds – The flight to quality took on a whole new meaning in the fourth quarter of 2008. Long Term Gov't Bonds experienced the largest quarterly move I have ever seen in my twenty years with the bond market. Eighty-two percent of the yearly gain came in the final three months! So, it should come as no surprise that Long Term Gov't bonds have claimed the number one spot in my relative strength work. Money Markets took the largest drop, on the other hand, falling five spots. Long Term Corporate had the largest move upward – jumping six spots. As usual, we will continue to rely upon our time-tested relative-strength analysis to guide our bond investments.



Forecast –

Bull Markets and Recessions

Isn't the headline wrong? Shouldn't it be reading Bear Markets and Recessions, rather than Bull Markets?

No, because I wanted to offer some food for thought. The current bear market started several months before the start of the recession, which is a normal course of events. The broad based Market Environment Indicator turned bearish on November 5th, 2007, and, with the exception of a short three week bullish call in August 2008, has remained bearish ever since.

But it is also normal for a new bull market to emerge before economic recovery begins. In other words, while the economy will still be in a recession, the news will be terrifying, earnings will fall, and unemployment will rise, but the market will start to look forward to better days.

Using historical data provided by Ned Davis, I have learned that the past ten recessions have been associated with cyclical bear markets that have tended to end about four months before the end of the recession. The market anticipated the subsequent economic recoveries.

While the U.S.'s economic problems are huge, the public's response in terms of monetary stimulus has been equally large. Add to that fiscal stimulus from a new administration and indications point to a positive turnaround in the future. The market at some point will anticipate the turnaround, which historically begins four months prior to the actual economic low point.

Several prominent economists are calling for a weak 2008 4th quarter to be followed by an even weaker 1st quarter 2009. But the 1st quarter may be the low; they are then calling for a flat 2nd quarter, followed by modest gains in the 3rd and 4th quarters of 2009.

If the economic low does occur during the 1st quarter 2009, then, counting backwards, the late November low in 2008 would be approximately four months prior to the economic low – meeting the historical standard.

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.