Portfolio Commentary

From the Alder Financial Management team | Issued July, 2008

Second Quarter Review

As we progressed through the second quarter of 2008, we began to realize that the markets have not changed significantly since our last commentary. The issues that have plagued investors over the last nine months are persisting into the latter half of this year. While some positive developments have occurred, namely the Federal Reserve leading the economic fight, the same head winds of falling real estate values, growing inflation, higher oil prices, falling stock market, and increasing credit concerns continue to burden the economy. While these conditions endure, we will undoubtedly remain in the same economic malaise. The economy is in dire need of some positive news, and though it will come eventually, the present economic disruption may persist longer than many of us would have expected.

We have grown accustomed to many of these problems, but one concern that has grown tremendously over the last few months is the dismal state of the banking and mortgage industries. The health of these industries is crucial to the survival of our economy. The second quarter saw a dramatic increase in banking problems with continuing real estate trouble and souring loans placing a great deal of stress on this sector. Capital positions diminished as many banks suffered losses on their loan and mortgage portfolios, and once these capital reserves reached critically low levels, these banks were forced to raise new capital to maintain regulatory status and remain in business. And while banks normally issue additional equity or preferred stock to raise capital, this is not an option in the current markets because increasing the amount of either would put downward pressure on the prices of existing shares. For the time being, banks in need of capital have turned to the preferred market, which creates the dilemma that most money managers and their clients face; as banks have tapped into the preferred markets on multiple occasions, they had to pay continually higher interest rates which effectively reduced the values of existing shares. This quandary occurs because banks were issuing preferred stock at higher rates to begin with, such as 6.5% to 7.5%. While those yields would be acceptable given the rate environment, the same banks were forced to pay 8.5% or higher for any new capital only a few months later. Therefore, the older issues decreased in market value; however, they would still be generating yields that would be considered handsome by historical standards.

“Cash Flow is King”

There is an old saying in the investment world that “Cash is King” during market anxiety, but we think “Cash Flow is King” is a better statement. If your investment goal is to generate wealth that can be utilized for future retirement income, the focus should be on the cash flow of your portfolio, which is exactly what we do. This is especially true in today’s turbulent times. People easily become gripped by the daily market fluctuations, but generally it is a waste of effort to worry about something you cannot control. Instead, focusing on cash flow as you near or enter retirement is more beneficial, and it is absolutely the right strategy now or anytime. So while our bank preferred holdings may decline in market value, we can balance this frustration with the historically high yields they are producing. As time passes and the banking sector begins to improve, we expect the pricing of our bank preferreds to improve. Of course, this would be in addition to the already high cash flow.

“Fear Factor”

As many of you know, the popular “Fear Factor” television show forces contestants to do things they may find hard to stomach in order to win the contest, which is not very different from today’s economic environment. Watching the market swing up and down may be difficult to stomach, so we feel it makes more sense to relax and put the current market tribulations into historical perspective. While the reasons may be different, the markets are acting as they have during any of the previous economic downturns. Historically, one of the main reasons for negative activities in the market is the fear of the unknown, which is no different from the current episode of questioning the soundness of the economy and the banking system. Asking questions can be informative, but it is generally counterproductive to question and fear the unknown. This is exactly what is presently happening. There are still unknowns that must be explored and corrected before we can move forward, so we continue to believe it is more productive to focus on the variable we do know, which is cash flow. As long as we can produce cash flow for our clients, we can weather any storm. To help you get a better idea of your cash flow, we have included a report detailing your last 12 months of cash flow generated.

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