

November 17, 2008

Dear Valued Investor:

I have been asked why I did not foresee the pattern of events that led to this sizable collapse in the financial markets. I've asked myself the same question. Although the troubles started with subprime debt, a relatively small part of the debt market, they snowballed; producing losses in global equity markets about thirty times the total amount of subprime debt outstanding. My search for the answer has taken me through an examination of what we now know to be deeply flawed parts of the financial system, very, very poor decision making by Wall Street and other financial institutions, poor security selection and extremely high leverage in these firms' balance sheets, along with lax regulatory oversight, rating agency failures, serious market design failures and the like.

Recent discussions regarding our nation's aging highway infrastructure set me thinking about the parallels with our aging financial infrastructure. With bridge failures, how can experienced engineers and bridge builders charged with maintaining and repairing aging bridges not see the danger? I know bridges are complex, but there they are, right in front of their eyes. They have the blueprints, construction and repair histories of bridges, are aware of prior disasters, but still sometimes miss the gravity of the situation. There are many possible factors in a bridge failure; design and construction mistakes, inadequate inspection, maintenance, and bad repair decisions over the years. Once a collapse has occurred, it is much easier to see the failures and their causes.

It is the same with our financial system. You may not know, but the basic structure of our system was put in place more than seventy years ago. We now see there were significant design flaws. Of course, over the years some of the flaws were addressed with revisions and new legislation, but some of the repairs were insufficient. And some attempts at repair actually did damage, like, in my opinion, the repeal of the Glass-Steagall Act. Also, the regulatory environment became too lax—a case of inadequate inspection. And bear in mind that the folks making a lot of decisions and revisions to the system over the years were mostly not experienced financial system engineers; they were politicians. They were making decisions to fix things in response to observed weakness, but also in response to interest group pressure, political and social objectives and other factors that ended up, on balance, weakening the system's integrity. Over seventy years, a lot of bad decisions can accumulate. Most folks knew there were problems with the system, but very few saw with clarity the extreme nature of the risk and could articulate the problems in a convincing fashion. It is one thing to say the sky is falling; it is another to have a cogent, detailed explanation of why it is falling that will convince others to act. The subprime debt problem proved to be the last straw for a weakened financial structure.

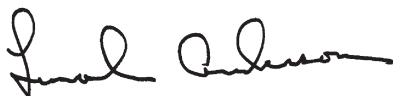
As with bridge failures, parts of our financial system collapsed suddenly, and now we have to assess the damage, figure out short-term work arounds, come up with short-term solutions to get the system up and running again, get rid of the rubble, study the mistakes made and learn from them, soberly design the new system, get agreement on the blueprint, and then rebuild. I am convinced the result will be a much stronger, much less risky and better designed financial system. Certainly still somewhat flawed given the political process, but much sounder with seventy years of accumulated design flaws and repair errors cleared out. And those errors are now very much in view; such is the nature of collapses.

Current Congressional, Federal Reserve, Treasury and other U.S. agency actions are in my view dealing with short-term disaster recovery operations. There will likely be more such action coming from a lame duck session of Congress. We have already lost sizable wealth from the financial system collapse and are now, in my opinion, in what will be a significant recession with losses in income and employment. While I expect at least six months of bad economic reports, I think, but am by no means sure, that the big loss in wealth in equity and debt markets is behind us. Although financial markets may, like bridges, collapse pretty fast; economic downturns and recoveries take more time. However, I do not believe these problems will hold us back for too long. Given the actions taken to date, I think the chances of another depression are very slight. I continue to expect an economic recovery next year.

The next phase will be making sure we have the right programs and policies to minimize collateral damage (the recession) and then next year move into the “learn from mistakes, redesign, get agreement on the blueprints” phase and then get going on rebuilding the financial system. There will be plenty of stuff that gets chucked, some quickly. In my opinion we are not going to have unregulated mortgage originators or complex unworkable securities being issued, we are not going to have highly levered financial institutions with unreadable balance sheets, or unregulated hedge funds and credit default swaps. We will have a highly regulated financial system from top to bottom with very complete reporting of transactions, positions and risk. All these potentially risky hidden business practices, securities, balance sheets and new innovations are going to be subject to much more stringent inspection. Thankfully, a large number of community and regional banks avoided these horrendous problems and are functioning relatively normally.

So what have I learned from all this financial destruction that has exposed so many flaws and provided so many painful lessons? Plenty. I have laid aside the frustration I felt at seeing such widespread stupidity and cupidity and am learning and moving ahead constructively. I will be laying out my lessons learned in future letters. Again, I do not know that we are at a market bottom, but do think the risks are more balanced given all the damage done. As always, please call your financial advisor with any questions or concerns.

Sincerely,



Lincoln Anderson  
Managing Director, Chief Investment Officer

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