ADVISER INVESTMENT MANAGEMENT

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investment Management

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The Fed Slashes Rates

In a move that surprised us somewhat, the Fed cut interest rates by 50 basis points (or 0.5%) to 4.75% on Tuesday. We had expected a more moderate cut of 25 basis points, but apparently the Fed is less concerned about inflation than they are of the impact of the credit squeeze on the slowing economy.

Perhaps they were bolstered in their decision by the fact that producer prices for August came in lower than expected, or that inflation was down 0.1% for the month, contrary to expectations. The Fed did caution that despite deciding to cut rates, it still sees inflation risks and that it would be monitoring them closely.

The reaction to the cut was immediate, and marked, with the Dow and S&P 500 indices, among others, racing to their biggest gains in over 4 years. The Dow finished up 2.5% on the day and the S&P 500 had a 2.9% gain.

There are many who stand to gain from this cut--homeowners could see lower mortgage rates over the coming months, investors may see more stability in what's been a volatile market, and for financiers and borrowers around the country it could make getting loans cheaper.

That said, it will take from several months to a year for the full effects of the cut to be felt in the economy at large, and there are some potential downsides as well. For example, we could see a rise in inflation and a weakened dollar, especially if the Fed continues to cut rates in the coming months. In addition, it doesn't offer much help to folks trying to deal with rising mortgage payments, falling home prices and a weaker job market.

While we have discussed in prior updates how the Fed would possibly have to intervene on the markets' behalf, what we are left to wonder is whether and to what extent the Fed cut demonstrates a negative view of the domestic economy and by extension, the global one.

The actions also clearly express the view that our economy was slowing more measurably than previously thought due to protracted pressures in the housing market, reflected in the jobs market as well, and a perceived slower growth rate overseas.

The action, as dramatic a move as we've seen from any Fed, suggests to us that the co-pilots at the Fed had suddenly felt an increased fear of stalling--leading them to inject a richer mixture of rate cuts than even the Fed Funds futures had predicted. (The futures had predicted a 100% chance of a 25 basis point cut and a 50% chance of a 50 basis point cut.) Now that the cuts have been made, that fear of stalling may have only seen a temporary reprieve. (The Fed Fund futures are now predicting an 85% chance of another 25 basis point cut when the Fed convenes on October 31.)

The fact that the Fed was willing to take immediate and decisive action suggests that they will do so again, which seems to give some validity to recent naysayers. Nevertheless, the pressures remain. On the recession front it will come down to job creation and consumer spending--something we watch keenly and will continue to watch closely in the upcoming months for signs of further weakening. On the inflationary front, historically high energy prices mix with volatile but inflationary food prices to put a damper on consumer and business spending.

The Fed (and investors) will need to remain on top of the situation while managing not to overreact when the markets might look shaky, which they undoubtedly will from time to time. Now that we know that this newer Fed is willing to step into the fray, we see no reason to deviate from our long-term strategies, designed to help our clients through interesting times such as these.

Vanguard to Open Extended Duration Treasury

Vanguard is scheduled to open Extended Duration Treasury this Friday. The fund, which we wrote about in our July 11th update, will be benchmarked to the Lehman Brothers STRIPS 20-25 Year Equal Par Bond Index, created specifically for Vanguard. (STRIPS are zero-coupon bonds that have been "stripped" into an income generating component and a principal component.)

As we mentioned previously, Extended Duration Treasury is not a fund for the faint of heart, as it will carry a great deal of interest rate risk. While the institutional and institutional-plus shares come with hefty minimums of $5 million and $100 million (there is no investor share class), there will also be an ETF of the fund available for the average investor, with a 0.14% expense ratio.

This fund should offer a good play on interest rates, but we would be hesitant to recommend it to any but the most educated and risk-seeking investors.

About Adviser Investment Management, Inc.

Adviser Investment Management, Inc. is an independent, professional money management firm specializing in Fidelity and Vanguard mutual funds. With 1,400 clients and $1 billion dollars under management, Adviser is one of the nation's largest mutual fund research and money management firms. Our staff of 27 investment professionals focuses on helping individual investors, trusts, foundations, and institutions meet their investment goals. Our minimum account size is $350,000.

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