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December 23, 2008

The Fraud and the Fed

The recent revelation of the massive \$50 billion fraud perpetrated by Bernard Madoff Securities has swept the media and the markets, and should serve as a wakeup call to regulators who were clearly napping on company time. But the scandal, beyond being a disturbing parable of greed and treachery come to life, also highlights the benefits of working with firms where transparency and integrity are key components of the business plan, companies such as Adviser Investments, Fidelity Investments and the Vanguard Group.

The problems at Madoff's firm began with the fact that he acted as his own broker/dealer and custodian. Client statements did not say Fidelity Investments or Charles Schwab. They listed "Bernard L. Madoff Investment Securities, LLC." Hence, they were open to fraud. Madoff controlled what the statements said, and obviously manipulated them to reflect the fiction of ever-growing balances month to month, when the reality was quite different.

When clients work with Adviser Investments, their assets are held in custodian accounts by Fidelity Investments. We serve simply as an agent with limited rights to conduct transactions in clients' Fidelity accounts—we do not hold their securities at Adviser Investments. Accounts at Fidelity are regulated by the Financial Industry Regulatory Authority (FINRA) and backed by the Securities Investor Protection Corporation (SIPC).

But the greater lessons to be taken away from this situation are some of the classics that we at Adviser Investments live by. The first is to always understand the investment process and philosophy of the investment manager you work with. Very few of Madoff's clients actually understood what he was doing. If they had, they'd have known it could not possibly succeed. At Adviser Investments we believe transparency in the work we do, and in our investment philosophy, is paramount.

Secondly, there is no free lunch. The notion that someone could guarantee small, consistent returns month after month for years on end may have raised some eyebrows, but it apparently wasn't worrisome enough to keep investors from giving Madoff billions. If it seems too good to be true, without a doubt, it almost certainly is.

Finally, the idea that hedge funds, and funds-of-funds, and high-net

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worth investors are somehow more sophisticated, or smarter about how they invest, or can generate higher returns for their clients, is simply false. Again, there is no quick and easy path and investors in the funds that invested with Madoff are now paying a very high price for their ignorance.

We believe our investment process and strategy is sound, transparent, and time-tested. All of Adviser Investments' employees and principals invest in the same funds and managers that our clients do. We are committed to our strategies, with the knowledge that short-term volatility is just a part of the long-term path to prosperity.

Historic Rate Slash

On December 16th, the Fed cut its fed funds rate by 75 basis points, naming a zero to 0.25% range as the target rate. The cut was made in a hope that the unprecedented low rate range (never before seen in the U.S.) would help to cut deflation and ease the global credit crunch.

This position means that the Fed can't cut rates any more and will have to engage in what's known as "quantitative easing" to get the economy moving. This involves, among other things, buying Fannie Mae and Freddie Mac debt to bring down mortgage rates, something it's already said it would do, and possibly buying long-term Treasury bonds, also to bring down interest rates. It is also with the realm of possibility that the Fed could step into the corporate bond market, the municipal bond market and even the equity markets if it wants to inject more liquidity into the economy. The trick, of course, is that it must do this until the economy begins to fire up again and then quickly begin to remove liquidity before inflation begins to burn.

Looking at the fundamentals of the market, earnings are heading in the direction that we thought they would; and while that direction is down, the market has also priced in the trajectory and, due to the extraordinary selling of September through November, had priced in an arguably worse case than has currently been shown to exist. Nevertheless, the Fed's recent rate action reflects their concern that the absence of buyers not only persists as a systemic risk, but could increase in negative effect.

However, they're beginning to move mortgage rates by their actions, one cornerstone of a sustainable recovery will be built on the foundation of a stabilized housing market. The fact that we got the worst building permit and new home starts reports last week suggests that builders are as pessimistic about that recovery as they've ever been—but demands for housing don't vanish into the air of such pessimism. It persists. And if we're producing roughly half of the annual demand for new homes, the good news is that it will put pressure on the still lofty inventories, and when they come down (sometime by mid-2009 we might begin to see this) the next step will be an amped up demand for more homes—made more affordable if the Fed can continue to exert downward pressure on rates.

The absence of buyers may be reaching its apex on Wall Street, too. There's palpable hope in the direction and spending pledges of the incoming administration. There's every fundamental reason to bargain hunt in each marketplace and in every capitalization range. We're heading into the annual time frame for funding our retirement oriented accounts. And the cash sitting on the sidelines is getting increasingly impatient. (Herein lies the aforementioned risk for another day—if that cash springs back into the market, and the Fed has printed excess

money, the velocity of another bubble could be unstoppable.)

The consumer, who apparently is beginning to actually save a little, versus spend, spend, spend, is getting a big stimulus in the form of lower oil and gasoline prices. On December 18th, in fact, despite the cutbacks that OPEC has promised in an effort to bump up prices, oil closed at just a bit more than \$36 per barrel, a four year low, which is about \$8 or so below where it was when OPEC began its talks. Now, the economy of course would do better if consumers spent rather than saved, but so long as their personal balance sheets are improving, and deleveraging, we believe the spending could come back as those gasoline "cuts" put more money in pockets, and businesses find their raw material costs going down as well.

As always, we will have to wait and see, while trusting in our managers to make good on the bevy of opportunities arising daily.

Another International for Vanguard

On December 11, Vanguard announced plans to open World ex-U.S. SmallCap Index in the first quarter of 2009. The fund will be available in open end investor shares, institutional shares, and, as is the norm with new indexes coming out of the firm in the last several years, ETF shares.

World ex-U.S. SmallCap Index will be based upon the FTSE Global Small Cap ex-U.S. Index, which comprises more than 3,300 stocks of companies in 47 countries. If you recall, the last two new international funds added to Vanguard's roster were also based upon FTSE indexes.

Vanguard says that the fund will fill out their list of international investment opportunities, covering a previously untapped (in index and ETF form, at least) segment of the international market.

The investor share class will require a \$3,000 minimum initial investment and will cost an estimated 0.60% in operating expenses, the institutional shares will require a \$5 million initial investment and are slated to cost 0.35% in expenses, while the ETF shares are estimated to cost 0.38% in expenses (there is no minimum for ETF shares, but buying and selling shares will be subject to standard brokerage fees).

Once we have more data on this new fund and its underlying index, we will take a closer look at its long-term potential and possible place in a portfolio.

About Adviser Investments

Adviser Investments is an independent, professional money management firm specializing in Fidelity and Vanguard mutual funds. With 1,500 clients and \$1.2 billion dollars under management, Adviser is one of the nation's largest mutual fund research and money management firms. Our staff of 40 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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