DATE: September 18, 2008

Subject: The Current Market Turmoil: Questions and Answers

Dear BOS Clients and Colleagues:

In this email alert we want to address some very specific questions for our clients:

1. Are my investments safe at Charles Schwab & Co. or Fidelity Investments?
2. Is my cash safe in Schwab and Fidelity money market funds?
3. What is happening in securities markets and what can I do about it?

**Are my investments safe at Charles Schwab & Co. or Fidelity Investments?**

The answer is yes. First, understand when you have an account at Charles Schwab or Fidelity Investments you have not invested in either company. In other words, the value of your investments is not affected by what happens to Schwab or Fidelity, except in very rare instances.

For example, if you hold mutual funds at Schwab or Fidelity the money you invested is not held by Schwab or Fidelity. It is held by the mutual funds themselves. The only thing that will affect the value of your mutual funds is the price movement in all of the different securities held in the mutual funds’ portfolios. If the stock and bond markets go up or down, you will make or lose money; but you will not lose money in investments held at Schwab or Fidelity simply because Schwab and Fidelity may go down in value. Indeed, there will be no connection between the two.

Technically, the only time you could suffer a loss due to a failure of either Schwab or Fidelity is if securities are missing or are pledged for margin loans that cannot be recovered. This means that for individually traded stocks, bonds or ETF’s which are held in the name of Schwab or Fidelity for your benefit, a portion of their value could be at risk. This is an extremely rare event, but it is nonetheless a risk, even if small. Because of this, there exists SIPC insurance (Securities Investor Protection Corporation), which is a quasi-governmental entity that insures brokerage accounts up to $100,000 in cash and $500,000 in total securities. Over and above this, both Schwab and Fidelity purchase separate insurance that insures the accounts at much higher limits. Schwab provides additional insurance through Lloyd’s of London in an aggregate amount of $600 million, with a limit to any customer of $150 million in securities and $1 million in cash. Fidelity provides additional insurance through Customer Asset Protection Company (“CAPCO”) which is a surety consortium of broker-dealers. Fidelity provides coverage for all losses not covered by SIPC insurance.
Of course, even insurers can fail, as we have seen, so you need to understand this: Schwab and Fidelity are not the types of companies that are getting into trouble in this economic environment. They are not similar to Bear Stearns, Merrill Lynch or Lehman Brothers. Those companies have (or had) large investment banking operations. That means they purchased and owned risky securities, or lent lots of money to others who bought such securities. In contrast, Schwab and Fidelity are primarily money managers and brokerage concerns. They are not in the business of owning risky assets.

How can you be sure of this? There is one simple way. Look at the value of Charles Schwab stock which is publicly traded. It currently is trading only about 10% off of its 52 week high. In other words, the stock has not gone down nearly as much as the stock market in general. What the market is telling you is that Schwab is financially solid and not threatened.

Is my cash safe in Schwab and Fidelity money market funds?

Again, the answer is yes. This issue has been raised because a major money market fund, the Reserve Primary Fund, yesterday failed to maintain a $1.00 share value. Here is what happened: The fund had $64.8 billion in assets. Of that total, about $785 million was in debt issued by Lehman Brothers (which filed for bankruptcy protection on Monday.) Although the Lehman debt only represented about 1.2% of the fund’s assets, it was enough to cause a run on the fund. In two days, investors pulled out over 60% of the fund’s assets (about $39 billion.) That was too much for the fund to handle, and the net price per share of the fund dropped from $1.00 to $0.97.

The first thing to note is the obvious: Investors did not lose all their money. Indeed, they have only suffered a relatively small loss. But any loss in a money market fund (which is supposed to maintain a stable $1.00 share value and be safe) scares people.

Are the money funds at either Schwab or Fidelity exposed to the same risk that caused the run on the Reserve Primary Fund, namely do they have any exposure to Lehman Brothers debt? The answer is no. According to the Wall Street Journal, “Fidelity’s taxable money market funds now have no exposure” to Lehman Brothers debt. A release from Charles Schwab this morning states, “[We] can confirm that Schwab Money Funds do not own any Lehman securities.”

In other words, the taxable money market funds at both Charles Schwab and Fidelity have no exposure to the risk that caused the run on the Reserve Primary Fund.

Of course any money market fund has risk, as does any investment. In the history of money market funds, there have now been two funds that were unable to maintain a $1.00 share value (the first time it happened was in the mid-1990’s.) In both cases, the losses were small, not large. There is no indication that will happen with either Schwab or Fidelity money market funds. But what you need to understand is that in the case of
money market funds the risk, to the extent it exists, historically has been a risk of small losses, not large losses, and even those have been extremely rare.

Finally, you need to understand that the safety of the money market funds is not dependent on the financial health of either Schwab or Fidelity. The funds are only managed by Schwab and Fidelity. They are not investments in Schwab or Fidelity. The only thing that affects the value of the money market funds is the value of all the different investments they hold in their portfolios.

If you have CD’s or checking/savings accounts at a bank or savings and loan, those are liabilities of the bank or savings and loan, and could be at risk depending on the financial strength of the institution. FDIC provides up to $100,000 of insurance for deposits per individual depositor per institution. If you are under these limits, your money is safe. If you exceed these limits, you should consider moving your funds to another institution. If you are invested in a money market fund sponsored by a financial institution, there is no guarantee or insurance. In this case, it is important to understand what are the underlying securities held in the money market fund, and whether any of them represent holdings in organizations that might be in financial distress. If you cannot get a straight or clear answer from your institution on this point, you might consider moving them to another money market fund.

What is happening in securities markets and what can I do about it?

What is happening to securities markets is that the financial system is undergoing a major and traumatic re-capitalization. This is because financial institutions in the United States and elsewhere made a lot of bad loans to people and entities that could not pay the money back, or invested in other companies that made such loans. A whole lot of money ("capital") was lost. That capital must be replaced. That is the process of re-capitalization.

The first problem is that there is not enough capital in the private financial system in the United States to provide all of the new capital that is needed. If the private financial system cannot provide the needed capital, then it can only come from two other sources: foreigners or the U.S. government. In the fourth quarter of last year, foreigners (usually in the form of sovereign wealth funds) pumped about $60 billion in new capital into U.S. financial institutions. Then they got burned. They lost money. They are not now willing to provide additional capital until the markets settle down.

That leaves the U.S. government. The government must provide the additional capital that is needed or the financial system will suffer major disruptions. And the government will provide the additional capital, and will do so for just that reason. Moreover, the Federal Reserve, in conjunction with other central banks and the U.S. Treasury, has the capital to do so.
The fact is that investors in the short-term maintain high confidence in the United States. You can judge that confidence by looking at what has happened to the yield on 3-month U.S. Treasury Bills over the past few days. A week ago the yield was 1.58%. Today the yield is 0.06%! Yields drop on Treasury bills because so many people want to buy them that the U.S. Treasury doesn’t need to pay as high interest as before and people will still buy them, and today the U.S. Treasury does not need to pay virtually any interest.

It also means that tremendous amounts of capital are flowing from the private sector into the U.S. Treasury. In turn, the U.S. Treasury must utilize that capital to re-capitalize and maintain the financial system.

There will be big bumps in the road. The U.S. Treasury and the Federal Reserve will not save everyone. They will only save those companies that are essential to the smooth functioning of the financial system, such as Fannie Mae, Freddie Mac and AIG. You can think about it this way: A company like AIG is like the motor oil in your car’s engine. It is a very small part of the engine, but if it is not there the engine will seize up. In other words, a company like AIG provides the lubricant that allows all kinds of other things to run properly, such as the financial system. That is why the Federal Reserve and the Treasury had to save it. In contrast, Lehman Brothers was more like a spark plug. It’s an important part of the engine, but if it goes bad the engine isn’t destroyed. You can replace the spark plug.

There will be more bad headlines. For example, Washington Mutual, which is the nation’s largest savings and loan, is in serious trouble. Our guess is that it will need to be taken over, either directly by the government or through an arranged merger with another institution with the FDIC insuring depositor accounts. But the government will not save it beyond the FDIC’s insurance obligations because Washington Mutual is not essential to the functioning of the financial system.

Finally, what can you do? First, understand your objective. What we do know is that if you can avoid big losses in major bear markets then you will do fine long-term as an investor. In other words, the objective is not to avoid all losses (if you do that you will eliminate virtually all return) but to limit them. That has been the great benefit of widely diversified portfolios in this bear market. Virtually all of our clients have suffered losses far less than those you are reading about in the headlines, and far less than the stock market in general. In that sense, things are working.

However, you must ask yourself this question: If the market drops another ten per cent (and it will only do so if people feel that things look much worse than they even do today) will you decide that enough is enough and sell out your portfolio? It is likely that will be a very unwise decision, and if there is a significant likelihood that you will feel compelled to do so you should act now to prevent it. The only way to prevent it is to reduce the equity (stock) percentage allocation in your portfolio to a level where you will not feel compelled to sell everything if things get significantly worse. For example,
if your portfolio is currently allocated 80% to stocks you could reduce the equity allocation to 70% or less.

If you do so, you will reduce your short-term risk, but it will come at a price. The price is that it likely also will reduce your long-term return. There will be a trade-off. The likelihood is that you will not be able to time your reentry into stocks well enough to avoid missing out on a significant part of any future upturn. In other words, the loss in future return likely will more than offset any current avoidance of loss.

That is the tough choice. We recommend that as long as your portfolio is doing what it is designed to do, which is significantly limit your losses in major downturns, you should stick with it. Once again, the only exception is if there is a substantial risk that you will sell out your portfolio if things get significantly worse. That means your current portfolio is not right for you (it is too risky) and you should give us a call so we can change it to a risk level that is more appropriate.

Finally, in general it is much better to keep your head while everyone else is panicking than to panic. These kinds of sudden market sell-offs historically are typical of the end of bear markets and not the beginning of bear markets. For example, in the great bear market of 1973-74 the biggest sell-off came in the third quarter of 1974, just before the bear market ended. Similarly, in the great bear market of 2000-2002, the biggest sell-off came in the second and third quarters of 2002, just before that bear market ended. In other words, the ends of bear markets are much scarier than the beginnings. It is only when things look so bad that no one thinks things are going to get any better that the bear market ends.

We are realists. Unemployment is going to rise. The federal deficit will increase. Business growth will slow or stagnant. Corporate earnings have already fallen substantially and will continue to fall. The housing market remains moribund. But most of these events are already reflected in stock prices (that is why the market has fallen so much.) We are approaching the point where stock prices are so low that stocks will offer competitive long-term returns even in the face of all of these problems. At that point, the market will stabilize and recovery will begin.

An old adage is true of securities markets as it is of most of life: “It is darkest just before the dawn.”

Bingham, Osborn & Scarborough LLC