



AMERICAN FINANCIAL ADVISORS, LLC

Market Commentary 1st Quarter 2008

The first quarter was disconcerting for investors in general and some of our clients, particularly those who closely follow financial markets and frequently check their portfolio values. In times like these where no one can predict the direction of the markets, we appreciate the importance of our communications with you that include e-mailed articles, phone conversations, and these commentaries. Let's review the first quarter market volatility and discuss our thoughts surrounding this environment.

The S&P 500 declined almost 10% in the first quarter of 2008 even when including dividends. This was the worst 1st quarter since 2001 when the markets declined 12%. Normally the market rises in the first quarter of the year as contributions from retirement plan contributions and employee incentive payments are invested. The market's uncertainty about the duration of weakness in the economy was reflected in the level of volatility of stock prices during the quarter.

Volatility -- as measured by the number of daily moves greater than 1% in either direction -- approached levels not seen since 1987. These large movements represented half of the trading days during the first quarter. (The good news is historically these spikes in volatility have usually been followed by strong upward moves in the months that follow.)

The definition of a "bear market" is a downward move of at least 20%. The S&P 500 still hasn't reached "bear market territory", but it sure feels like it since the equity markets have fallen 18.6% since the highs of October 2007. The S&P 500 peaked at 1565 on 10/09/2007 on a closing basis. The lowest close since then was on March 10 at 1273, a decline of 18.6%. This may be splitting hairs but with the big rally that took place on April 1, to start the 2nd quarter -- the S&P 500 bounced meaningfully off its lows and is now only down 15.5% from the October peak.

{Note: These definitions of a "bear market" or "recession" can drive you crazy. Even if we aren't in a textbook bear market or recession by definition, it still feels like it in many households. For example, the government numbers say core inflation has only ticked up from 2.7% to 3.3%. But when you fill up your gas tank, buy groceries, pay your utilities, property taxes, medical bills, and write the checks for your kids' in college -- it definitely feels like inflation is much higher. }

Further, Small Capitalization and International stocks also declined about as much as the S&P 500 -- so in this current market, diversification among stocks provided little relief. The exception was REITs (real estate investment trusts) which appreciated about 5%. Investors who were diversified into commodities also benefited as they were up strongly in the quarter. Investment grade fixed income (bonds) provided modest gains and helped mute the volatility, as expected.

The big story of the quarter was the rescue of Bear Stearns. Bear was highly leveraged and heavily invested in the risky spectrum of mortgage securities. Because of Bear's relationships

with so many other investors, the Federal Reserve reasoned that a failure of Bear risked a collapse of the financial system. So the Fed is backing JP Morgan's acquisition of Bear.

The Fed has taken a number of additional actions to support the financial system and stimulate the economy. While they have lowered interest rates to 2% (Fed Funds rate) -- the effect has been muted because banks are less willing to lend. The silver lining is the financial system has re-learned an old lesson – do not make unwise loans. But, as usual, the pendulum has swung too far in the other direction – and will take time to return to “normal”.

Tighter credit, weaker payrolls, and rising food and gas prices have shaken consumer confidence. The capital markets also do not like the uncertainty created by the current political climate. Essentially, we have a lame duck, unpopular President whose policies are being blamed for the economic problems. This is leading to populist proposals including higher taxes and protectionism.

It is very possible we have entered the first consumer-led recession in a decade. Its duration and depth are impossible to predict given the weakness in the housing market. On the positive side, the global economy remains robust. Corporate earnings outside of the financial sector and homebuilding industry have been reassuring. It remains difficult to divine what will restore consumer confidence in the US and when that will occur. Lower interest rates, controlling inflation, and stabilizing the housing market will be key elements of any recovery.

As a whole, things have been “gloomy” the past six months – but we still remain comfortable owning stocks for the long haul. First, given earnings estimates at this time, stocks are attractively valued particularly when compared with bonds. We reiterate that our horizon for evaluating the market is five to ten years. We recognize stocks may go lower before rising. The alternative of owning all bonds and cash is much less attractive given their low interest rates, real rate of return based on potentially high inflation. We can't sacrifice the buying power of your dollar – especially as a retiree that may live 25-30 years past your working years.

Stocks offer significant upside when the economic recovery materializes. We do our job by staying diversified across various asset classes and not missing the larger returns when they occur – which can happen quickly. While a recovery in the near term may be hard to imagine, we remind ourselves of the liquidity that has been provided, international demand caused by a weak dollar, and government stimulus from the Fed. These are all reasons to be disciplined, control emotions, and patiently wait for the recovery.

No one can know when the recovery will materialize. But when the markets start to move higher again in a sustainable upswing, stocks will rise dramatically because there will be an increase in earnings estimates and the price to earnings ratio will expand.

For the past 6 months, we have held higher cash positions than normal to help weather the obvious volatility and downward trends, but we now feel the risk of being out of the market exceeds the risk the markets will move lower and stays down for years to come.

Thus, our view is that the worst is probably over – even if we re-test the March lows one more time. Earlier in the year we took some risk off the table and held more cash in many of our models. Now the premium for risk is back and we are moving back in. We made adjustments in January and will continue moving more cash back into various sectors, by tweaking the portfolio allocations and dollar cost averaging into existing holdings.