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Mid-Year Update

2008

Individual Asset Management is a
Registered Investment Advisor

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Points of interest:

- **Focusing on sectors instead of the broad market can be helpful at times like these.**
- **The latest on broker investment scams.**
- **A well-run US natural gas company whose share price has been pummeled - see "Investment Focus".**

Market Update

As I write this towards the end of July the picture for investment markets continues to be murky. Data in the form of unemployment numbers, home sales, GDP, and various inflation measures generally tells us that we continue to be in a low-growth, moderately increasing inflationary environment in much of the developed world and a high growth (but slowing), high inflation environment in emerging markets.

In the United States we continue to see financial firms write down the value of their mortgage-related assets and the write-downs are now spreading to consumer debt such as auto loans and credit cards. American Express recently reported an increase in their delinquency rate, which is worrying since they have a largely well-off clientele. Merrill Lynch just announced that they sold off a large part of their remaining CDO portfolio (Collateralized Debt Obligations - a type of asset backed security) at 22 cents on the dollar to a Private Equity firm. Not only did they take a huge loss on the transaction but they also had to provide financing for the deal

to the PE firm. At the same time Merrill also raised more cash from a large institutional investor in a share sale which they not only had to finance but also had to in effect subsidize by giving the purchasing firm money back on a previous share purchase they had made at a higher Merrill Lynch stock price.

Such stories are common these days - it never ceases to amaze me that private investors trust their money to firms like Merrill Lynch when clearly these firms cannot even properly manage their own investments.

We have also entered what hopefully will be the final stage of the housing and credit crisis in the US - bank failures. Two weeks ago IndyMac Bank, a large US sub-prime mortgage lender failed and was taken over by government regulators. This was the second largest bank failure in terms of assets in US history and yet the markets did not collapse. Last week two smaller banks in Nevada and Arizona failed and no doubt we will continue to see bank failures for many Fridays to come (the government

regulator takes the bank over on a Friday so that they have the weekend to sort things out before opening to the public on Monday). I would be especially careful in keeping large amounts of money with banks that do business mostly in California, Nevada, Florida, and other places where housing prices are plummeting and mortgage defaults increasing.

Unemployment in the US and other parts of the developed world is now increasing at an uncomfortable rate and inflation is making its way up the food chain from producers to consumers. Consumer spending has slowed, especially on big-ticket items such as autos. The economic stimulus package that the US government made available recently probably will only help in the very near term and I expect much of it will be used to pay down consumer debt rather than being spent.

In Europe and emerging markets we are seeing what may be the beginning of a wage/price inflationary spiral where labor demands higher wages to offset price inflation.
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This is less of a problem in the US due to the smaller influence of organized labor. This is a serious problem in a low-growth environment such as the one we are now experiencing in most developed markets.

Another serious problem is developing in certain emerging economies; most importantly India and Russia. We are seeing inflation increasing despite government policies aimed at reigning it in. The Indian equity markets have responded negatively, down 40% year-to-date (but after a great run for several years previously). Inflation is also an issue in many other emerging markets in eastern Europe, China, Latin America, and elsewhere.

All of this suggests that the global economic situation could get worse before it gets better.

However, there is also some

encouraging news. The housing situation in the US is still very challenging in the worst-hit markets such as California, Nevada, and Florida; but in other parts of the country some stability has returned to housing prices. The US government has stepped in with considerable support for the mortgage industry and home owners in an attempt to help mitigate defaults. An unlimited line of credit has been extended to the two firms, Fannie Mae and Freddie Mac, that underwrite 70% of mortgages in the US. Further economic stimulus packages are being enacted, and interest rates remain low.

We are currently in second quarter earnings season where publicly-traded companies tell us how they are doing. The picture is mixed, with continuing challenges to many financial and housing-related companies and poor sales reported from many retailers. At the same time

large technology companies are reporting good earnings, helped by increasing sales to emerging markets. Industrials give a mixed picture, with many reporting good non-US sales but also being negatively affected by rising commodity prices.

Another encouraging sign, at least in the US, is that there is a lot of money sitting on the sidelines at the moment and just recently we have seen a number of funds formed to take advantage of the distressed securities market.

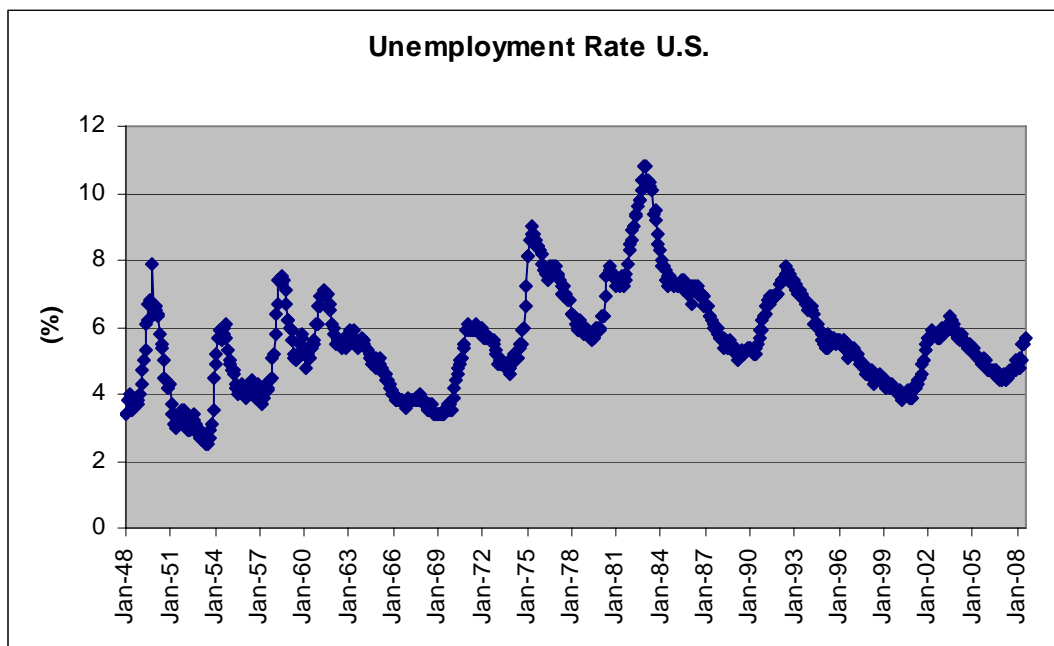
Furthermore we have recently seen oil prices trend downwards and there is a movement afoot to limit speculation in commodities markets, which should help decrease volatility.

We haven't seen any more high profile financial firm failures such as the Bear Stearns debacle in March. We are

seeing increasing bank failures in the US but by and large it seems this should be limited to regional banks.

Also some of the bad news out there falls into the "bad but not terrible" category. For example, it is true that the unemployment picture in the US is getting worse - but at 5.7% unemployment, the overall situation is hardly disastrous (at least not yet). The US and European economies have slowed down but are not in recession by any common measure despite continued forecasts that this should occur. In fact the International Monetary Fund recently increased its forecast for global and US growth over the next two years.

The caveat is that it isn't terrible YET. Things could certainly get much worse, especially if unemployment continues to rise in developed markets and if inflation doesn't abate.



Below is a chart showing returns and correlations for various global market sectors as well as corresponding returns for the same US market sectors. It is interesting to note that there has been a large difference in both returns and correlations over the last year between certain sectors. In fact, diversification amongst sectors has been much more useful this year than international diversification in general as broad markets in the US, Europe, and many other parts of the world have declined in unison.

The large differences between sectors show that it has been a stock-picker's and asset-allocator's year and that a buy-and-hold strategy invested in broad markets hasn't worked.

Given the continuing negative economic situation, we might

expect such an investment scenario to continue. In which case the question is whether to continue investing in the sectors that have outperformed or whether to try and profit from a bounce-back in beaten down sectors. In my opinion, as long as the economic, housing, and financial situations do not show solid signs of improvement, then trying to time a sector turnaround will be dangerous. Many sophisticated investors have gotten burned over the past year trying to buy financials at what they thought was the bottom.

Having said that, there are certainly compelling valuations amongst certain financial companies - but considerable research is required to separate the wheat from the chaff as there will no doubt be further bankruptcies in this sector in the weeks and

months to come.

Traditionally utilities, consumer staples, and healthcare are considered to be defensive market sectors that investors turn to in a down-market. However, in this market, where commodity prices are increasing, companies in the consumer staples and utilities sectors may face price pressures from rising raw materials costs. Healthcare and technology companies are less sensitive to commodity price increases.

The point of this article is to highlight that attention needs to be paid to sectors when it comes to diversification and not just geography. For example, the broad Mexican stock market is weighted 40% to the telecom sector, whereas the Taiwan market is heavily weighted to technology.

“Attention needs to be paid to market sectors when it comes to diversification, not just geography

One year ending 08/04/2008	Materials	Consumer Discretionary	Consumer Staples	Energy	Financials	Healthcare	Industrials	Technology	Telecom	Transportation	Utilities
	MXI	RXI	KXI	IXC	IXG	IXJ	EXI	IXN	IXP	IYT	JXI
Returns (Global)	-1.9%	-25.3%	-0.8%	-1.1%	-30.1%	-5.9%	-18.1%	-12.3%	-14.5%		-1.0%
Returns (US)	4.3%	-18.8%	-5.6%	3.3%	-32.7%	-3.9%	-13.3%	-11.7%	-32.7%	-2.7%	-7.5%
Correlations (Global)											
MXI	1.00										
RXI	-0.05	1.00									
KXI	0.46	0.50	1.00								
IXC	0.43	-0.12	0.11	1.00							
IXG	-0.12	0.98	0.49	-0.14	1.00						
IXJ	-0.27	0.81	0.46	-0.15	0.84	1.00					
EXI	0.21	0.95	0.66	0.01	0.93	0.74	1.00				
IXN	0.23	0.87	0.57	0.09	0.85	0.74	0.92	1.00			
IXP	0.11	0.84	0.75	-0.03	0.85	0.86	0.88	0.86	1.00		
IYT (US only)	0.57	-0.02	-0.06	0.32	-0.08	-0.40	0.11	0.16	-0.23	1.00	
JXI	0.52	0.26	0.85	0.21	0.24	0.41	0.43	0.48	0.67	-0.14	1.00
08/04/2008	70.00	44.15	56.60	41.90	60.96	54.63	53.18	55.98	61.26	88.14	61.17
Range	26.98	18.92	12.44	92.06	40.34	10.96	15.88	16.33	22.44	24.25	13.60
Minimum	63.12	42.52	54.64	39.31	54.06	50.85	52.49	54.32	60.60	74.11	58.97
Maximum	90.10	61.44	67.08	131.37	94.40	61.81	68.37	70.65	83.04	98.36	72.57

I feel compelled to write a somewhat self-serving article outlining why investors should not entrust their hard-earned money to large brokerage firms. The last time I wrote an article like this was in the spring of 2003 when ten Wall Street investment banks paid a total of \$1.4 billion to settle charges of conflicts of interest and fraud related to issuing biased stock research in return for investment banking work.

Investors who counted on this research and who expected their brokers to act in their best interests lost billions of dollars as a result of these dirty tricks in 2001 and 2002.

The tricks have changed but the culprits are still the same. These days it is all about auction-rate securities. These are securities that certain brokerage firms sold to clients by telling them that they were as safe as money markets but had a higher yield. Clients (and often the sales person as well) didn't understand how these securities worked and

that their value and liquidity were related to mortgage markets. When these markets dried up, many auction-rate securities plunged in value and, in many cases, investors weren't (and still aren't) able to even sell them since there are few buyers these days.

Currently Merrill Lynch, UBS, and a number of other brokerage firms are being sued by various investors (and several US States) as a result of these auction rate tricks. Apparently a number of these firms, especially UBS, increased the commissions paid to their sales people (brokers) to get rid of the auction rate securities they had on their books when it became apparent that the market was drying up. In other words, they are accused of lying to their clients so that they could sell them investments that they suspected were going to plunge in value.

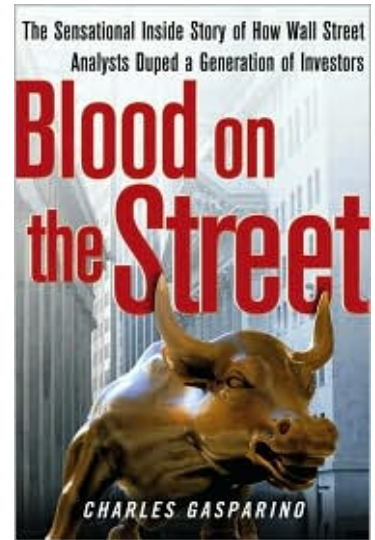
Doesn't this sound like the 2001, 2002 scandals all over again? Different dirt, different pile - same gardener shovel-

ing it.

On top of the continuing dirty tricks and lack of loyalty to clients, it has become exceedingly clear that many of these same firms cannot even be trusted to manage their own investments. Billions of dollars in write-downs, begging foreign sovereign wealth funds and institutional investors to buy new shares to support their balance sheets, leaning on government authorities to support them - all as a result of poor investments made with huge leverage in the mortgage markets. Does this sound like a company you want to trust with your investment dollars?

Yet despite it all, private clients still continue to do business with these firms - even though there are many other companies offering the same services and assuming a fiduciary responsibility to their clients (brokers in the US do not have fiduciary responsibility to their clients - only investment advisors do).

It boggles the mind.



Some light reading for those who like to entrust their savings to large brokerage firms.

A few headlines - past and present

WASHINGTON (CBS.Marketwatch - April 28, 2003) - In an historic \$1.4 billion settlement Monday, the government charged Merrill Lynch, Credit Suisse First Boston, and Citigroup's Salomon Smith Barney unit with issuing fraudulent research reports to win lucrative investment banking business. The Securities and Exchange Commission said seven other firms involved in the settlement distributed research reports that contained exaggerated or unwarranted claims.

NEW YORK (CBS.Marketwatch - March 17, 2003) - The Securities and Exchange Commission charged Merrill Lynch, and four former executives, with helping Enron Corp. overstate its financial results. The SEC's lawsuit, filed in U.S. District Court in Houston, alleges that the nation's largest brokerage and the four former executives helped Enron manipulate its earnings by engaging in two fraudulent year-end transactions in 1999.

NEW YORK (CBS.Marketwatch - September 16, 2003) -- New York Attorney General Eliot Spitzer filed criminal charges against a former Bank of America executive, and suggested that other cases will be filed, in a widening investigation of the mutual fund industry.

Aug. 1, 2008 (Bloomberg) -- Four days before Merrill Lynch & Co. stopped supporting the auction-rate securities market and left thousands of individual investors stuck with securities they couldn't sell, the firm's analysts recommended clients buy. "Reports of the imminent demise of the auction market seem to be greatly exaggerated, again," analyst Kevin Conerywrote in a Feb. 8 research note. "We continue to be impressed by the auction market's resiliency."

The remarks show Merrill's researchers were "co-opted" during a seven-month drive by the New York-based firm's sales force to prevent a meltdown in the \$330 billion market, Massachusetts Secretary of State William Galvin alleged yesterday in an administrative complaint filed in Boston. As the sales desk pushed analysts to publish upbeat notes, managers used gallows humor to com-

INDIVIDUAL ASSET MANAGEMENT, INC.

San Francisco office:
580 California St., Suite 1200
San Francisco, CA 94104
tel: +1 (415) 439-4891

email: iam@iamadvisors.com
web: www.iamadvisors.com

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Our focus is purely on portfolio management and financial advice, we do not have conflicts with investment banking concerns and our research is entirely impartial. Our clients enjoy access to the professionals who actually make investment decisions, not just to sales representatives.

As times have illustrated, a static portfolio strategy cannot be effective in every economic climate. At Individual Asset Management we develop a strategy that is appropriate for market conditions as well as for your specific goals and risk tolerance.

This newsletter is for informational purposes only, it is not intended to offer advice or guidance on legal, tax, or investment matters. Such advice can be given only with full understanding of a person's specific situation.

Until next time,

Tom Zachystal, CFA, CFP®, EA
President & CEO

Investment Focus - CHK

Chesapeake Energy (NYSE ticker: CHK) is a company that has been in our clients' portfolios for a number of years. The company is the largest natural gas producer in the US. Chesapeake saw its stock price increase from \$5 per share to \$40 per share from 2002 to 2005 as the price of natural gas more than quadrupled and the company grew by acquisitions as well as organically.

The stock price spiked from \$45 to \$75 in the last quarter as a result of high natural gas prices and reports of a large natural gas reservoir find. The stock has been pummeled in the month of July as a result of the general selloff in commodities and is currently

again at about \$45/share (as of end of July, 2008).

This is a stock that is, once again, worth looking at. Chesapeake management recently have made it clear that their acquisition spree should slow down and they will focus on monetizing the investments they have made over the last few years. This should be good news for shareholders as it should mean less capital spending and a focus on margin and profit growth.


Company management has also recently announced discoveries that substantially increase Chesapeake's gas reserves.

According to a company in-

vestor presentation, management assigns a net asset value of \$116/share to the company with natural gas selling at \$9 (which is where it is at the moment, having spiked to \$14 last month).

This company is a long-term hold in my opinion provided natural gas prices do not crater. Chesapeake is exceedingly well-run by the same top management that founded the firm many years ago and that still maintain their original stake.

It may also be an opportune time to buy as we enter the Caribbean hurricane season - a time when natural gas prices often rise.



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