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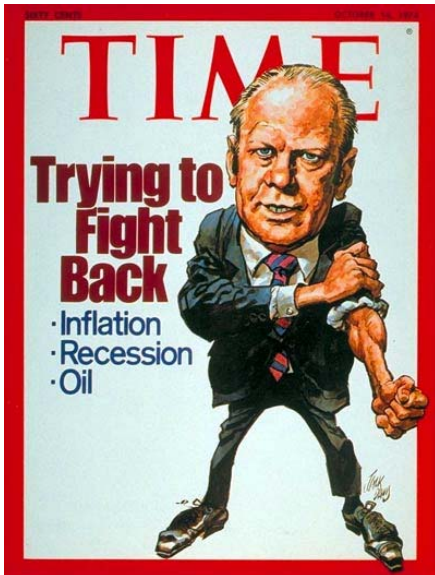
Leveraged

Emotions

March 2008

Dear Clients and Friends,

It sure feels like a lot has happened since I wrote in January. The financial markets have covered a lot of ground, but in the same way that I cover a lot of miles. I travel frequently between Honolulu and Albany, NY. Lots of miles, same territory. My rut in the sky. The markets have moved back and forth within a range from the recent low of around 11,600 on the Dow Industrials, back to 12,700 or so and everywhere in between, several times. Lots of motion, little distance covered. On January 15th, when I wrote the previous newsletter, the DJIA was at 12,500. Today, March 10th, the DJIA is at about 11,740 and will most probably return to the lows of January before this is all over. Perhaps one more good scare might be in the cards as well. It seems that if we are not convinced that the world as we know it is about to end, "the markets" (read institutional powers, the very same folks that brought us this mortgage and credit "crisis") won't be satisfied.



Of course, the background context has, indeed, changed. As expected, the Federal Reserve has lowered rates aggressively and will do so again this month. Congress has passed a "stimulus package" that will return as much as \$180 billion to tax payers, starting in May or June. Banks, brokerage firms, mortgage companies, housing construction companies, private equity and hedge funds have and are writing off huge loses. Bond rating and insurance companies have trembled. Warren Buffet, foreign capital and "sovereign funds" continue to drool over America "on sale!" And, we, the investors in the great companies of America and the world, continue to experience the financial markets and press induced "apocalypse du jour."

Speaking of which, here is the cover image from the October 14, 1974 issue of Time Magazine. The DJIA was at about 700. Sure, the themes are familiar, but the context and the world today are very much unlike.

And that is the point. This is NOT a return to the mid 1970's.

The rest of the world isn't cooperating with that gloomy

prospect. In the face of all this fear, billions of people still go to work every day to create a better future for themselves and their families. Our victim-oriented financial markets are not going to change this.

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THE ART AND SCIENCE OF WEALTH MANAGEMENT

Yet, there are some significant issues affecting all of us, whether in the developed world or developing world. Perhaps the current stress will induce a more determined effort to move ahead. Certainly the technology is present. What has been missing is the will to act.

1974-1975 were significant down years in the U.S. equity markets. The economy struggled with significant geo-political tension, oil embargos and shortages, aging manufacturing infrastructure and declining productivity, Viet Nam fatigue on all levels. We almost convinced ourselves that "rust belt" America was the residue of a once dynamic economy. Many felt that the great wealth creating machine of the U.S. economy had seen its best days, the cost of the cold war had undermined our strength and global population growth and scarcity of natural resources dominated our attention. The pundits of the day nodded knowingly that we were headed for long-term decline. Watch out below!! Our financial markets and economy struggled to find direction for 8 years. In 1982, seven years before the collapse of cold war tensions, the most powerful renewal of business and markets in history began and, with some very brief stops along the way (1984, 1987, 1990, 1994, 1998, 2000, 2008?), has continued and will continue, in my opinion. Why? Because, notwithstanding what you read and hear in the financial press, on balance, businesses, governments and investors actually learn (at least something) from experience.

To be frank, some of what has been learned isn't so inspiring. I'll highlight only a few examples of the good, the bad and the ugly. Let's begin with the more positive lessons.

The Good:

Technology

It's a huge understatement to say that technology has radically transformed everything, including itself. The integration of silicone and carbon based micro- and nano-technology applications and advances in materials science, over the next 25 years, will dwarf what we have seen over the past 25 years. We can barely comprehend, much less appreciate, the scale and scope of how this continual and radical transformation has the capacity to improve material life on earth. Yes, this includes solving many of the very same problems we have created, particularly nutrition, health and environmental concerns. We are so immersed in this radical transformation that it has become unseen. The staggering impact is experienced with such a casual acceptance as to give rise to an attitude of "been there, done that," always desiring TNBT ("the next big thing").

Manufacturing

The dynamic process of manufacturing, from raw materials supply to fabrication to global distribution, has incorporated methodologies that are orders of magnitude more efficient than what existed 35 years ago. How else has the global GDP risen from the ashes of WWII to a 2007 global GDP >\$72 Trillion?

Energy

There is no energy shortage, just a shortage of the will to implement the range of solutions that engage the more advanced methods of harnessing or generating, transmitting and using energy. The lack of will relates directly to current domestic and global political and short term financial realities. The present concerns about energy, including environmental, financial, resource management and usage center on political and financial considerations, not science and technology. It is important to note that, at least in the U.S., we produce more than three times the output per barrel of oil than we did in 1974. This is at least one reason why recent high oil prices have had much less effect on the economy than many expected.

FOOD

So far, increases in global food production have increased sufficiently to provide significant improvements for hundreds of millions of people. The average calorie intake on the planet has increased dramatically in recent decades. Areas of famine have largely been caused by political realities, corruption and waste.

Financial

The recent swell in mainstream awareness of socially responsible investing has caused many investors and institutions to rethink the criteria by which they measure appropriate investment allocations. The awarding of the 2006 Nobel Peace Prize to Muhammad Yunus, founder of Grameen Bank in Bangladesh symbolizes the increasing awareness of how creative approaches to money have begun to transform the inner workings of the global financial markets. Micro-finance is already being embraced by some Wall Street institutions and many private groups, foundations, endowments and individuals are deeply committed to changing the very nature of how financial markets serve people.

The Bad:

Energy

Environmental, political and financial concerns continue to determine energy issues around the globe. The cost of oil, denominated in U.S. dollars has reached actual, inflation adjusted, all time highs. But note, that even with the increases, the cost disproportionately affects Americans, since in local currencies, the price has benefited by the lower value of the dollar and the consequent strengthening of other currencies. For example, buy dollars with a strong Euro and buy oil with more dollars. The cost has risen for all, but not at the same rate. The rate of growth of global economic activity will strain all sectors of the energy markets, particularly the production of electricity. Ironically, the older infrastructure, environmental concerns and political differences will cause great strain on U.S. electricity production in coming years. The newer economies aren't as burdened with some of these issues and will do whatever it takes to secure the energy resources and production needed to move on. This means that the "fossil fuel" economy isn't about to go away in the next decades, no matter how high oil prices go. Coal, an even less desirable energy source, can keep things going for a long, long time. It's in the highest interests of the world to accelerate the transition to the spectrum of alternatives. I'm not confident in the probabilities of this happening on any large scale sooner rather than later, much later perhaps. The "clean up the mess later" mentality isn't restricted to western democracies.

Food

So far the world has been able to increase food production sufficiently to easily offset population growth. However, simple population growth isn't the only demand factor. As the millions and soon billions of new "middle class" members emerge around the world, the demand is also for much of the same kinds of foods developed economies take for granted. This adds much more stress to the supply system. In addition, some kinds of agriculture are now seen as useful for energy supply (ethanol). There are also concerns about alternative ways of developing food varieties (genetic engineering) and preserving foods (irradiation). If the world's food supply is to keep up with the demand, a clearer consensus about sustainable agriculture is needed. More effective uses of land and water are seriously needed to increase sustainable production. Otherwise, the scarcity issues that have so far been largely created by political forces may become more widely experienced.

Financial

The developing interdependence of economies and markets around the world has had a significant positive impact. The best result is the dampening of large scale military conflict and promoting large scale increases in standards of living. People generally don't blow up their own stuff. The more we "co-own" and depend on each other economically, the less inclined we are to destroy. This is why it's so important to expand the experience of increasing abundance to billions during the transition from subsistence to increasing abundance. At the same time, the competition for resources and markets can and is increasing tensions around the world. The last time there was a large scale reduction in global trade, it was a major factor in inducing the depression of the 1930's. This result is in no one's interest and is very likely to be avoided. However, trade skirmishes at the edge are likely to increase.

The advent of easily accessed global capital markets has been a major cause of the integration of global manufacturing and services. It has also raised the transparency of markets. Capital simply won't flow, even if allowed, to countries where it can't function with the assurance that the legal, accounting and market systems we take for granted in the developed economies. Increasing global capital markets have

raised the standards around the world. However, it has also created opportunities for types of speculation that add increasing complexity and risk to the markets.

The opportunities are significant. Not only will capital flow to higher return market opportunities around the world, it will also be a source of the venture capital, supporting entrepreneurial visions and creative enterprises wherever they may originate. In addition, the opportunity to more broadly allocate portfolios over a wider range of assets is made possible.

On the downside, complex financial instruments, often highly leveraged, find their way into portfolios around the world, particularly institutional portfolios. This is largely unknown territory and therefore also holds unknown risks. More on this point under "The Ugly." Diversification depends on what are called "correlations," positive and negative. Asset classes that tend to move up or down together are called "positively correlated." Asset classes that move in opposite directions are said to be "negatively correlated." As a risk management tool, these correlations matter. If all markets move together, then we lose an important risk management technique. So far, this hasn't happened, but more highly integrated economies and markets move us toward dynamics we haven't yet had to experience.

The Ugly

Environmental

As the Berlin wall came down (1989) and the countries behind the iron curtain (when was the last time you heard that phrase coined by Winston Churchill?) opened up, it was dismaying to discover the degree of environmental damage that was done under the centralized communist economies. At least democracies could create mechanisms to address issues like this when they became unacceptable. Modern environmentalism, which began in the 1960's, took up many causes that raised awareness, standards and had definite results. I recall as a teenager how degraded the water of the Hudson River was and on two cross country road trips, how far away we could identify the polluted air of cities we approached along the way.

Increasing standards of living have traditionally demanded remediation of environmental degradation. As difficult as this has been, it has resulted in genuine improvements. Of course there are still important needs to address. At the same time as developed economies move ahead, developing economies are, in a highly compressed cycle, tracking the early stages of industrialization, but on a scale never before seen in history. Massive air, water and ground pollution are adding to the existing global concerns about the range of environmental issues. One could argue for a long time about "peak oil" or fossil fuels and CO2 emissions, but the question of clean water may emerge as the more immediate area of conflict. We have energy alternatives. We don't have massive clean fresh water substitutes.

The hope is that as wealth increases in Asia, South America and Africa, the higher standards of living will demand cleaner environments. As I mentioned above, these are issues of will and finance, not technology. What standard of living is sufficient to live with unbreathable air and undrinkable water? The environment doesn't know about geographic, political or cultural boundaries. It is in all of our interests to encourage continuing improvements from all economies, particularly those that promise to grow to sizes that are multiples of the current developed world.

Financial

Here we come to the central topic: ugly financial markets. All markets tend to go to extremes both up and down. The current credit market extreme grew over several years of speculation, compounded by lower qualifying standards for many kinds of loans and unsustainable real estate prices. The log jam in the credit markets is located in the confidence needed for lending, not the availability of capital. The Federal Reserve has basically told the markets that whatever money is needed will be made available. However, financial institutions have had to massively de-leverage to write down their bad loans, take some bad debt back on their balance sheets to get it off the market, which had basically valued it at zero.

So, as the Fed hands out the money, the banks take it in to "re-liquefy" and not to lend. Lending is their business and, at the moment, they are afraid to engage in their primary business. This can only be

temporary. If they don't lend they can't make any money over the long run. All economies depend on the functioning of the credit markets. As the losses are exposed and written off, as the private equity and hedge funds are forced to de-leverage to survive, this brings the cycle nearer to a conclusion. Yes, the credit markets will be stunned and numb for a period, but will begin to reengage in their businesses, albeit with, we hope, higher standards, less mindless speculation and profit structures that don't depend on leverage ratios as high as 100:1.

Unfortunately, the credit market woes affect the real estate and construction markets. However, if the rampant use of leverage were only contained within the housing markets, there would be real pain, but not what we are seeing now. The credit markets have become a testing ground for exotic financial instruments that promise(d) the holy grail of money, the veritable financial perpetual motion profit machine.

This is the convergence of very intelligent people, who have extremely short attention spans, with access to massive computer power and a huge addiction to profit. This is the ugliest and most silent of the financial realities we are facing. The effect of this is a kind of "genetic engineering" of money. Snip this gene, glue together those genes, wrap the strand in a few more genes, immerse whatever it is in a world of bond insurance, program the new prime directive that profits are the most important product, incubate through newly global free flowing capital markets and, voila!, out come little black boxes of highly leveraged debt that are painted with AAA ratings in bright green. Not only is it hard to know what's inside, it's impossible to figure out how the boxes will interact when the proverbial butterfly in Japan makes the sound of one wing flapping.

This is the world of derivatives, a \$400-500 TRILLION swamp of financial toxic waste. In 1998 this was called "Long Term Capital." That is, before it collapsed. Three Nobel Prize winners founded that company. The irony is obvious. Gary Shiller, a perennially pessimistic economist, who I respect, but usually disagree with, recently noted that the current wave of losses has resulted in the de-leveraging of \$100 Trillion of derivatives, so far. This means that a very loud thud has occurred in the financial swamp, with few admitting to have heard the splash. Perhaps the latest credit market and financial services company pain will release enough swamp gas to relieve sufficient pressure to prevent an implosion. I think it will...for a cycle. It reminds me of the Santayana statement about being doomed to repeat history. For this cycle, too much is at stake and no government wants the global machine to grind down and seize. Credit lubricates the financial world. Like it or not, we must have it. The trick is to use it wisely, not recklessly as the recent past illustrates.

In the spirit of full disclosure, I did mention in the January newsletter that this is the closest I've gotten to cynicism in a long time. Investors are generally optimistic and confident types. I am confident that this latest cycle is passing. In fact, the time of maximum risk is when markets are at highs. At or near the bottom of market cycles, when so many are dreading the end of the world, we are actually closer to the end of the down cycle and risk is reduced or minimal. That's just about where we are now. Risk aversion is, in the end, profit aversion. The greatest risk to long term financial security is inflation or declining purchasing power, not stock market cycles. Investors who remain invested in well allocated portfolios tend to do much better through the inevitable market cycles, than those who try to time markets. The objective is to meet your life purpose goals, not to "beat markets" or your neighbor's self professed returns or abstract measures of success. The smartest people on Wall St. are the same ones that are currently losing the billions. Their advice about market timing is not exactly credible.

As I said in January, there is no shortage of money in the world. At some point soon, the entire picture will change, releasing the trillions of dollars in money funds, short term bonds and CDs for more productive investments. A recent report noted that there is \$3.9 trillion in cash on corporate balance sheets alone. Low interest rates will not indefinitely satisfy the need to maintain after-tax purchasing power. Only growing businesses can overcome inflation and taxes over the long haul. As I have said before, the stock market was not and is not overvalued relative to earnings. We were not and are not in a stock market bubble. We have been in a credit market bubble and it has already burst. Most businesses are still earning profits and seeking opportunities around the world. The financial services companies have a longer road to recovery. Some will fail or be bought out or merged. Individual home owners who took on more debt than they could sustain or made uninformed decisions will suffer and have a long road back

to financial health. In the end, millions of loans will be refinanced one way or the other. Some plans will be deferred. Other plans will be abandoned. It is inevitable.

For those who are looking to buy a home, the rest of this year will be the opportunity of a lifetime. Many will seize it. As confidence returns, real estate will become stable, interest rates will go up again and this moment of opportunity will pass for another cycle. Other sectors of our economy continue to advance in response to the need to bring billions of others into the world you and I take for granted.

Finally, The True and The Beautiful:

This current anxiety will pass. The U.S. economy is massive and capable of moving through these markets and whatever slow down or recession is in store. In fact, the stock market will respond way ahead of the economy. Once it is clear that the solution is in place, the equity markets will ignore the immediate conditions and become totally focused on the expected future growth and will want to own it now. We will emerge renewed, vital and creative. The deep impulse that is driving the transformation from thousands of years of scarcity to a future of abundance is stronger than any obstacle. Our current culture is embedded in the constant desire for "more." This is a subtle but very strong form of bondage. There are far more significant challenges ahead in the adjustment to a world of several giant economies interacting, interdependent and all dependent on a sound environment, respect for the world's cultures and stable social dynamics. Our material welfare is not an end in itself. It is a foundation on which to build the civilization which will release the human creative and purposeful spirit.

As ever, during the past 30+ years, here's to YOUR GOOD WEALTH!

Jerry!