Tillar-Wenstrup
Advisors, LLC

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REMEMBER WHEN A MORTGAGE WAS JUST A "MORTGAGE"

It is amazing to see the magnitude of some of the numbers being discussed in the mortgage market today. In the past mortgages were relegated to vaults of banks and savings and loans. In this newsletter we will look at what has changed and brought them and their problems to Main Street.

In the old days banks worked under a reserve requirement set down by the Federal reserve requiring banks to hold assets in reserve that corresponded to and in fact limited the amount they could loan in mortgages. In and around 1995 the fractional reserve system was dropped opening the door for almost unlimited lending-assuming there was a market to securitize (packages as securities) and thus sell off these mortgages that were being created. Thus the system no longer rewarded banks for making quality loans that they held as jewels on their books but instead rewarded them for volume as they processed and sold as many as they could. As you might expect, pressure for profits increased the need for volume opening the door for lending standards to be lowered and why not… the originating bank was not going to hold the note anyway. Gradually standards deteriorated to the point where little or no documentation was required for a buyer or refinancer to borrow money. All the while the securitization machine kept packaging loans in fancier packages so they could be sold making room for new loans at the bank.

To meet the need for increased lending volume lower quality subprime loans flourished creating a market of over a trillion dollars of subprimes now on the market. Combine the low quality of subprimes with tricky terms and conditions such as interest only, adjustable rates and a real mess arises. Pressures to produce volume encouraged the wide distribution of these option mortgages without real understanding by the borrower. Securitizing these loans complicated the investment system even further and as always uncertainty increased the problem when liquidity became tight.

So far most information investors are getting sounds very negative but it is important to remember that mortgage loans are made against a real asset. That is common to and important many. In some cases loans have been made for more than the asset is worth but the underlying real estate asset is rarely worthless. In time, if history is any gauge, the underlying value of real estate will rise again as will the equity value of the property. There are defaults but already there is an official effort with encouragement from regulators for banks to try to forestall foreclosures while the financial system stabilizes.

Meanwhile the Fed is trying to do its part by dropping interest rates and making additional liquidity available to the system as much as possible. Mortgage lenders who were starving just one month ago are seeing a dramatic pickup in loan volume as rates have fallen. Hopefully the increase in lending activity will begin to move the large inventory of properties and stimulate spending in the economy.

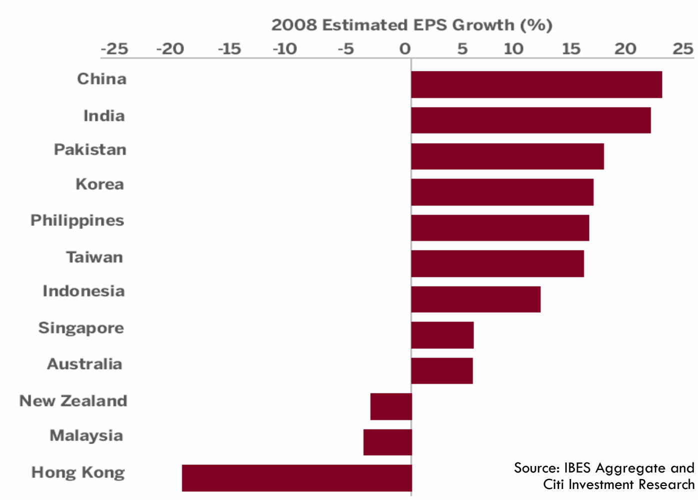
Lessons learned in the complex mortgage security market relate well to opportunities in the stock market. While lack of transparency in complex financial instruments led to the downfall of many financial companies, most companies outside the financial sector offer very transparent financial information. Today, the largest U.S. companies, in general, carry low levels of debt and high levels of liquidity. Because of their financial strength they are not restrained by relationships with financial institutions. Many stocks are at very attractive levels today. Could they go lower yes, but there are some great long term buys if you are willing to be selective.

I recently prepared a seminar for a broker in which we discussed past difficult stock markets. As an example we took 1987 a period where the market tumbled over 20% in one day. Looking back pre-crash, the market had been visibly overvalued and interest rates neared 10%. Clearly alternatives existed for conservative investors, but the Dow had roared, rising to overvalued levels in August of 1987. As most people know, the market fell around 500 points on the 19th of October to around 1700 on the Dow Jones Industrial Average. The previous high had been around 2700 reached in August. Looking back any investor whether he had purchased at the low (few were interested) or even at the high of August was rewarded well in the long run as the Dow has since seen levels of 14,000.

Today we see a market that has dipped nearly 20% from the October 2007 highs. Is it the bottom? No one knows but it appears most of the negative news and actions are either behind us or are expected news and priced into the market levels at present. The "buy low" part of buy low-sell high can often be the most difficult choice to make as typically the decision dwells within a negative investment environment. **Unless corporate earnings decline dramatically, valuations of many of our U.S. companies, at current levels, are attractive**.

Higher market volatility is likely to continue this year increasing the need of selectivity in ones portfolio. The global economy will continue to grow (see chart below) benefiting U.S. companies with a business presence in foreign markets. We continue to emphasize these issues in our portfolios expecting an economic recovery that the market will likely recognize and respond to before it becomes news.

Global Earnings-Growth Estimates



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