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Critical Questions & Answers about the Financial Crisis

*“A prudent man sees danger and takes refuge,
but the simple keep going and suffer for it.” Proverbs 22:3*

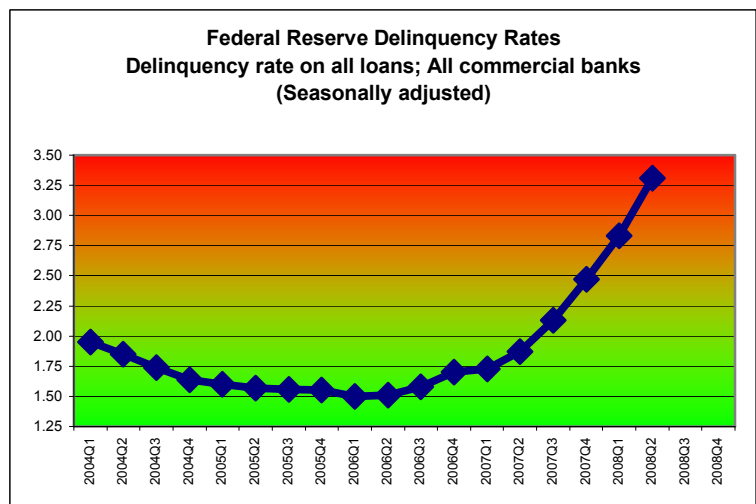
October 16, 2008

Recently, we called our actively managed account clients to talk about the markets, what we’re doing to mitigate risk and what we see going forward. Many clients had additional concerns and questions regarding the current financial crisis and what it means for the overall economy.

Question: After seeing the massive government rescue bill passed, I’m wondering if this is all just hype and meant to scare us into taking on nearly \$1 trillion in debt. Isn’t this just a government scare tactic?

Answer: NO! This is not just hype. The global financial system is on the verge of freezing up. The credit “pipes” are clogged and we’re watching US and foreign governments use every type of Drano and Liquid Plumber they have in their storage bin, with little success. Our global economy runs on credit. If there is no credit available, commerce comes to a grinding halt. The situation is so dire that when American Express polled their small business owner clients, 18% said they were fearful of going bankrupt, mostly due to a lack of available credit.

For years, anyone with a pulse could get credit. Now, you have to be Fort Knox to get approved. If massive debt built this economy up to where it is now, one can only imagine what the process looks like in reverse. It isn’t pretty.

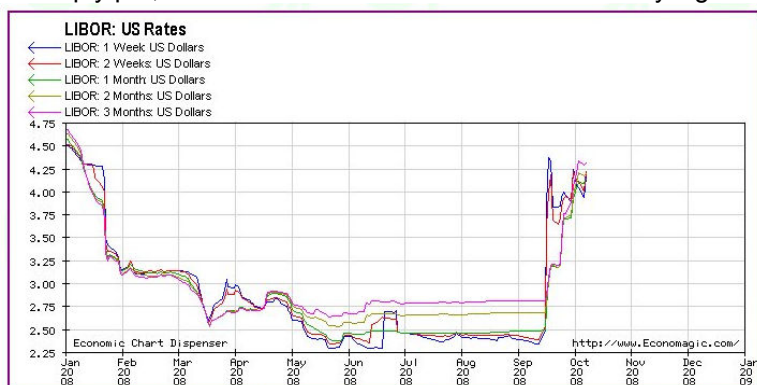


Delinquencies are soaring for all types of debt.

Unfortunately, the world is swimming in debt that can't be repaid, no more so than here in the United States. Commercial banks, corporations, the US Government and US consumers have built up mountains of debt over the past 20 to 30 years. Now, we're seeing the beginning of that debt being paid down.

Additionally, current interest rates play an extremely vital role in determining the volume of credit being extended. It also gives us a behind the scenes peek into what, if any, obstacles banks are facing in the creation of credit. In other words, as far as the credit crisis is concerned, this is the pulse of the credit creation machine.

The rate to check is known as the London Interbank Offered Rate (LIBOR). LIBOR is the rate of interest at which banks borrow funds in various currency denominations from other banks in the London wholesale (or "Interbank") money market. Simply put, the financial world watches LIBOR for any signs of stress in the system. If the rate spikes upward dramatically, it can be a sign of credit freezing up, sort of the "canary in the coal mine" scenario. A quick look at the accompanying LIBOR chart shows one of the reasons for the sudden sense of urgency in bailing out the banking system.



Back in late 2007, we spoke about this coming credit crisis. Back in February 2008, we talked about a Government "Herculean effort" needed to keep us out of a full-blown recession. Now, the entire industrialized world is throwing their weight behind stemming the tide of financial toxic waste. When it's all said and done, we could be looking at \$5 trillion to \$10 trillion of taxpayer funded, Government bailouts.

Debt Destruction

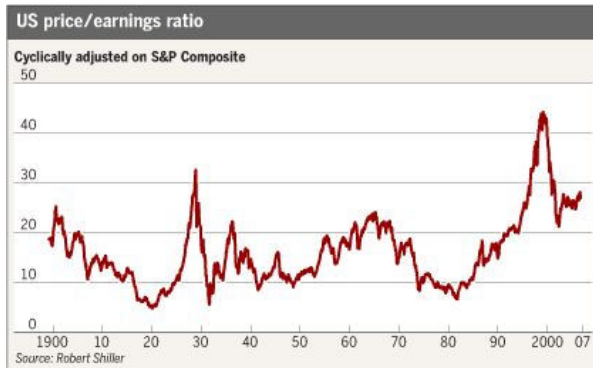
Reducing debt will greatly strengthen our country down the road. Unfortunately, that process is a long and painful journey. As a global economy, we have to pay down this debt that has a stranglehold on the economy. Unfortunately, when we're busy paying down debt and saving money, we're not going to be buying as many things as in the past. Since consumer spending accounts for 2/3rds of the economic activity in our country, you can see our dilemma.

Question: *The stock market has fallen off a cliff. Isn't this the time to buy up everything in sight? It can't fall much further, can it?*

Answer: It can always fall further, we just don't know if it will. The recent weeks in September and October were pure panic in the financial markets. Not only were stocks getting pummeled, but the "safer" investment, corporate bonds, were also seeing large declines. Investors are afraid of the coming corporate bond wave of defaults.

For a quick explanation, let's take a look at the most common stock market "value" barometer. This is known as the P/E ratio. Simply stated, it is a stock's price ("P") divided by the company's latest 12-month earnings ("E"). If a company's stock price is \$100 and their earnings are \$10 per share of stock, that company would have a P/E ratio of 10. So, for a quick snapshot of how "cheap" or "expensive" stocks are, we can use this indicator to see if stocks are currently at fire sale prices.

Over the past 100 years, the P/E ratio usually spent most of its time between 10 and 20. When it was 10 or below, it was considered "on sale." When it was 20 or above, it was considered "overpriced." Recent



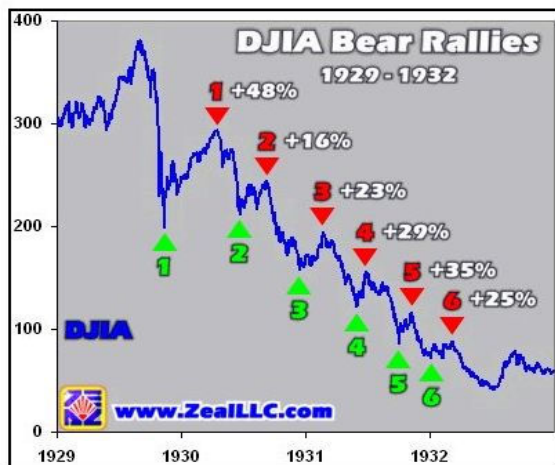
history shows us the two extremes. In the year 2000, stocks got so extremely overpriced that the P/E ratio blew right past 20, right past 30 and into an area that had never been seen before, not even during the roaring 20's. Subsequently, we saw stocks plummet back to earth during the 2000-2002 bear market.

The hard facts: The S&P 500 closed on Friday, October 10th, 2008 at around 900. It was at 1565 one year ago. For it to hit the magic "dirt cheap" P/E ratio of 10, the S&P 500 would need to hit 500. At 900, the S&P 500 P/E ratio is around 17. Also, keep in mind that the major bear markets take the market

down around 50%. We're down a little over 40%. If we fall to 777, we'll have wiped out 100% of all the stock market gains during the last 5-year bull market. However, during the Great Depression, stocks fell 86%. That would see the S&P 500 drop to 200. So, you can see just how risky the current investing environment is.

Question: The market just had its worst week in decades and then its best one-day performance since the 1930s. Was that the bottom?

Answer: Maybe, but I doubt it. We're getting hit by wave after wave of very bad news. Just when we think we can come up for air, we get slammed with another wave of even worse news. Even the multiple government rescue packages and programs don't seem to buy us anything more than rallies that last for several hours, days or weeks, at the most. Unfortunately, this cycle will not end until we have worked our way through this financial crisis. A partial laundry list of coming attractions: Non-Subprime mortgage defaults, credit card defaults, commercial real estate defaults, Hedge Fund liquidations, Credit Default Swap (CDS) problems, small bank failures, small business bankruptcies, corporate bond defaults, etc.



Historically speaking, all long-term (secular) bear markets have decent sized rallies within them. The 1929 to 1932 stock market collapse is a textbook example. Notice how the market tempted investors numerous times with short-lived potential gains, all the while driving down into the abyss of an 86% loss! That's dropping a \$1,000,000 account down to \$140,000!

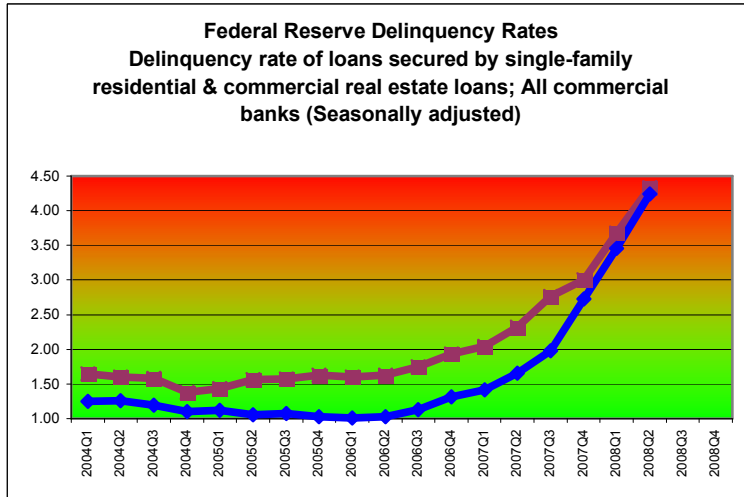
As I said, this is one extremely high risk, investing environment. It calls for prudent investing and a healthy dose of risk management through hedging techniques, such as the buying and selling of Inverse ETFs (these are exchange traded funds that go up when the markets go down). The Wall Street mantra of "Buy & Hold," which worked great during our last long-

term (secular) bull market (1982-2000), may leave unfortunate investors with major losses in their accounts. This is serious business.

Question: How could a small 5% default rate on subprime mortgages cause such problems?

Answer: We all know the subprime story. Just how bad is it? Well, the New York Federal Reserve Bank just released August 2008's numbers. Subprime mortgages, for the State of California, currently have 90 day past due delinquency rates of 9.9% and show 13.5% in foreclosure. That's nearly one-in-four

subprime mortgages that are blowing up. Also, the percentage of California subprime mortgages that have had late payments during the past 12 months is now 60.7%.

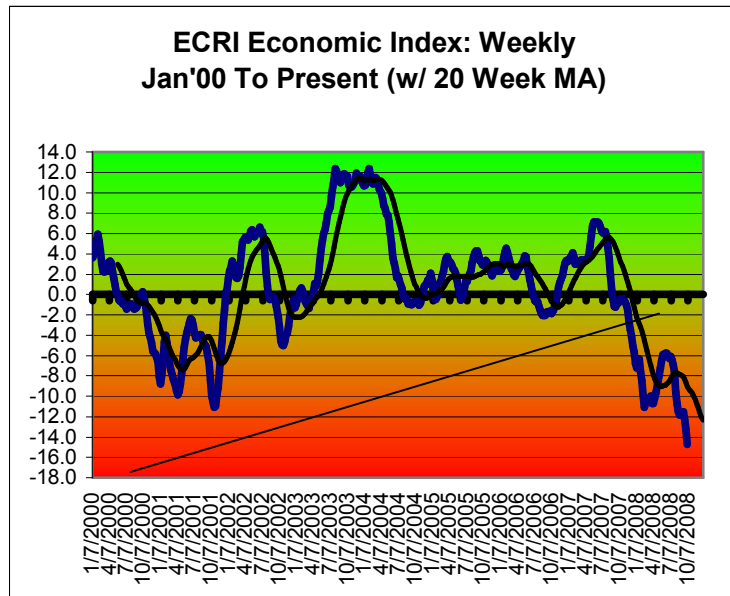


Real estate loans of all types are troubling, whether residential or commercial. After performing better for several quarters, commercial real estate loans are now showing the same level of stress as residential loans. Plus, the Fed hasn't released the most current figures, which will show more deterioration.

Remember, we were warning about this issue back in September 2007. The mortgage crisis was just getting started. We have an unprecedented multi-year decline for real estate upon us. Only time and price need to be worked out.

Question: I'm hearing that the Government's rescue package will unclog the financial system and the worst is behind us. Is that true?

Answer: Maybe. The rescue package seems to have many of the items needed to get the flow of credit running again. However, there's no telling if investors have the patience to wait around and see. Also, the plan may get the credit machine moving again, but it won't repair the economic damage that is yet to be seen. As we've said, we're already in a recession. We reported that in our 4th quarter newsletter from 2007. It quite possibly may become the worst economic downturn since The Great Depression. Much of



our level of pain relies heavily on how a new Administration treats the crisis. If allowed to "take the pain" now (probably not politically feasible), we may have a sharp, deep recession, but be on the road to recovery within a year or two. However, if Government tries to "manage" the downside to the economy, they may drag this out until who knows when.

Keep in mind, the ECRI Leading Economic Index (a forecasting tool for future economic activity) was pointing to a recession over a year ago. We printed this same chart in the 4th quarter of 2007. It was obvious even back then (unless you're in Government) that we were currently in or just about ready to enter a recession. Only recently are we seeing

just how severe it will probably be. Remember the above ECRI Index forecasts FUTURE economic activity. Since the chart is clearly showing further deterioration, the worst is yet to come.

For a vibrant, healthy economy to spring forth, we need reasonable real estate prices, a savings minded populace, prudent and ethical business practices and a much lighter debt load across the board. Maybe I'm asking too much, but if we can get our country back on track for a solid recovery, we have a good shot

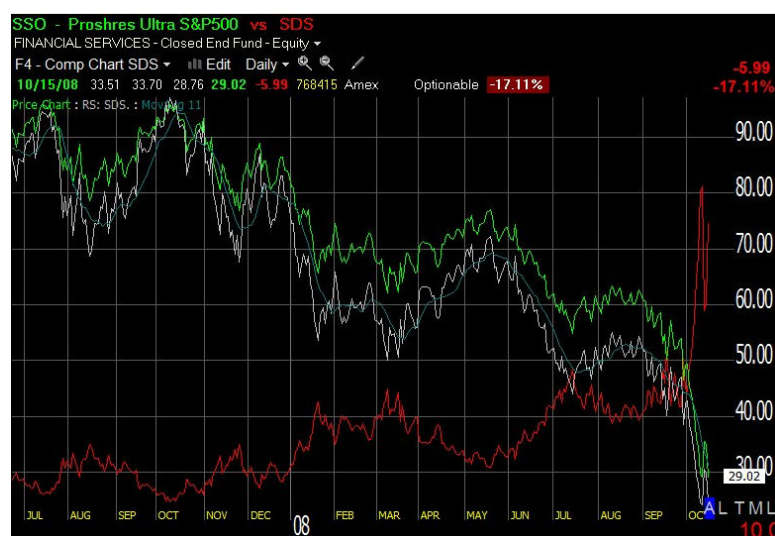
at coming out of this within a reasonable amount of time. With too many Government “solutions, bailouts, rescues, etc.”, we could be in for a long haul.

Question: *Recently, you said for year-to-date returns through mid-October, my actively managed account has held up very well. In this environment, how is that possible?*

Answer: We've been employing certain hedging strategies to help mitigate risk in this dangerous market environment.

The Eight Basket Strategy employs two layers of risk management. The first layer is the broad, truly diversified approach. By investing in eight separate asset classes, we reduce some of the risk in your account through this diversification process. However, when we enter markets where nearly all of the baskets are heading south at the same time for more than a few months (a rare occurrence), we employ the second layer of defense, which includes reducing exposure to stocks and/or using hedging strategies.

Right now, our risk management techniques are making all the difference. Mostly through the use of Inverse Exchange Traded Funds (ETFs), we have protected the accounts from large losses. That's not to say you won't suffer ANY losses, but we're trying our best to minimize any losses.



Again, Inverse ETFs are specialized funds that are designed to go up when the market goes down. By buying small portions of these funds during times of market stress, we have been able to make gains in these funds while the other holdings are simultaneously declining. The net result is an account that stays relatively steady throughout the market decline.

In the chart to the left, you can see how an Inverse ETF works. When the green line is declining (an ETF that represents the US stock market), the red line is advancing (an Inverse ETF).

Final Comments: We believe this information is vitally important for all investors. We're in a dangerous investing environment. Anyone you know with substantial money in the stock market needs to be informed of the risks they are taking.

Please pass this along to every investor you know. Feel free to forward this to everyone in your email address book.

If you are not currently on our mailing list, go to our website to sign up. On our website, www.optimusadvisory.com, there is a tab labeled “Eight Baskets.” Once you click on that tab, you will see a button to “Sign up for FREE email market updates.”

Please help spread the word that there are answers out there. We will be sending out frequent updates throughout this crisis.

Remember: Friends don't let friends gamble with their retirement!

Best Wishes,

**Steve K. Rumsey
Eight Baskets Portfolios
Optimus Advisory Group**

*“Divide your portion to seven, or even to eight, for you do not
know what misfortune may occur on the earth.”
King Solomon 940 B.C. Ecclesiastes 11:2*

An Index is a portfolio of specific securities (common examples are S&P, DJIA, NASDAQ), the performance of which is often used as a benchmark in judging the relative performance of certain asset classes. Indexes are unmanaged portfolios and investors cannot invest directly in an index. Past performance is not indicative of future results.

Investors need to be aware that no investment plan/asset allocation can eliminate the risk of fluctuating prices and uncertain returns.

Figures quoted are for illustrative purposes only and are not necessarily indicative of past or future results of any specific investment. They do not include consideration of the time value of money, inflation, fluctuation in the principal of, and in many instances, taxes.

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