

Third Quarter 2008 Review & Commentary

Overview

Traditionally in this space I briefly summarize the returns of various asset classes for the most recent quarter (in this case the third quarter of 2008, ending September 30th). This time, however, I think that the end of the quarter is a somewhat arbitrary cutoff and would ignore the 800 pound gorilla that was October. So, I'll cover the three month returns, or more accurately, losses through October 30th. While it would be more pleasant for me, and certainly for you, to gloss over this, I think it's important to review the situation as it is (or at least was a couple of weeks ago) and then in the commentary section review some of the underpinnings and try to build some realistic expectations.

Equities (Stocks)

Stocks were obviously hit quite hard across the board as emotional, indiscriminate selling dominated every asset class around the globe. Domestically, the Large Cap US stocks lost just over 23% for the three months ending October 31st. Riskier equity asset classes were even worse with the average Mid Cap fund losing 29% and the average Small Cap fund losing 26% for the period.

As bad as the US was, things were much worse internationally. International funds had an average loss of 35% for the period. Emerging Market funds lost an average of just 45% for the quarter, bringing their average one year loss to nearly 60%.

As testimony to the indiscriminate and irrational nature of the selling, Gold Oriented funds, which should do exceptionally well in times of panic, lost 50% for the period.

Fixed Income (Bonds)

Most bonds failed to provide a haven from the selling. The only exception, and indeed the single asset class with a positive return for the period, being US Short Term funds, which hold low duration government bonds. Even these were barely positive at less than 1/10 of 1% for the period.

Third Quarter 2008 Commentary

“Pessimistic visions about almost anything always strike the public as more erudite than optimistic ones .”

Joseph Schumpeter

What Is Going On Here?

What is going on here is a classic panic. Markets have simply ignored any underlying fundamentals and are acting on pure emotion. For proof of this we need look no further than the question “Is the world really a 40%-70% (the losses of various global equity markets) worse place than a year ago?” Hard to imagine it is. Further proof of the loss of rationality is the complete blind panic selling of any asset other than US Treasuries. As noted on the prior page, a drastic sell-off in gold along with financial assets is highly unusual to say the least. If you had said last year at this time that we would have a global financial panic and gold stocks would perform 50% worse than other stocks, it would have been nearly impossible to find anyone who would have believed you.

So Where Are We in The Credit Crisis?

The credit crisis is nearly 18 months old, which is pretty long in the tooth as these things have historically gone. The worst so far was the fallout from the Lehman Brother bankruptcy on September 15th. The following day, the government seized control of AIG, the giant insurer. Also on the same day, the first and one of the largest money market funds, the Reserve Primary Fund, “broke the buck” or fell below a \$1 share value. This was only the second time in the history of money market funds that one had done this, and the first major one to do so. By Wednesday September 17th, money market funds were starting to see a run on assets that looked like it was straight out of “It’s a Wonderful Life.” In addition, the credit markets had completely frozen. Banks wouldn’t lend to each other and businesses were unable to obtain credit to keep operating.

The next day on Thursday the 18th, Federal Reserve Chairman Ben Bernanke and Treasury Secretary Hank Paulson went to Capitol Hill with hat in hand, proposing a \$700 billion bailout package. When asked what would happen if the bill failed, Mr. Paulson responded with “If it doesn’t pass, then heaven help us all.” As we now know it did pass (on the second round), and in addition the US and other governments around the world have undertaken extraordinary actions to mitigate the credit crisis as well as the resulting recession.

The average person likely doesn’t have, and may never have, an appreciation for exactly how bad the credit markets got and how much they’ve pulled back from the brink in the last couple of months. The good news is that prior to this the Fed and Treasury had been behind the curve in the credit crisis. This was clearly an attention getter and they, and the rest of the world, now seem to be appropriately focused on the issues at hand.

In response to these events, the volatility of equity markets shot up from an average of 15 (as measured by the VIX index) to 75 and the Dow experienced its worst week in its 100-plus year history.

Since then, however, things have improved (at least on the credit front). Banks have begun to lend to each other as evidenced by the One Month LIBOR, (the interest rate at which banks lend money to each other) which has dropped from 4.59% on October 10th to 1.48% on November 11th. This was an extraordinary outcome to a dire situation. So it would appear that, at least at the worst levels, the credit crunch has been effectively addressed.

Why Isn't This the Next Great Depression?

There has, largely in the uninformed mainstream media, been talk of a 30's style depression. This is, in my opinion, completely overblown and unrealistic. The Great Depression was a function of incredibly overvalued stocks and numerous bad policy decisions (tight monetary and protectionist trade policies chief among them) which simply have not been the case in the current crisis. Just as medicine has come a long way since the 30's, so has our understanding of economics and fiscal policy.

I would also say that, like him or not, Ben Bernanke is probably one of the world's leading experts on depressions and panics, having spent his academic career studying them. The response to the crisis by the Fed and the Treasury, while in the early months lagging, has certainly shown itself to be flexible and responsive. The last reason I would cite for our ability to steer far clear of recession is that we have a far more flexible and dynamic financial system than we did 75 years ago.

Many economists are now saying that we have probably been in a recession since the third or fourth quarter of last year. If this is the case, we may already be most of the way through this recession. Unemployment is currently around 7%. In the 1981-1982 recession it hit just about 11%, and during the depression it peaked out at 25%. Clearly we are not in the ballpark of either of those.

Isn't This All Completely Unprecedented?

In terms of stock markets around the world, the events of October can be rightly referred to as a crash. The S&P 500 is down about 45% from last year's peak. So let's try to look at what may be some similar periods in history and see if we can draw some comparisons. Our most recent down market in 2000-2002 was down about 48%, so we haven't even hit the levels of the last one yet, let alone moved into unprecedented territory. Looking back a little further, the bear market of 1973-74 certainly stands out. Over the two years the averages were down about 50%, so we haven't quite gotten there either, at least not yet. In '87 stocks fell about 34% from their highs to lows, but included a one-day drop of nearly 23%. So for emotional impact, it was right up there and has current events beaten at least in terms of sheer drama. In the Long Term Capital

Management crisis of July and August of 1998 (the last leverage and derivative debacle) stocks fell nearly 20% in six weeks.

Perhaps one of the best parallels is the crash in Great Britain in the early 1970s. Their real estate market collapsed, setting off a similar chain of events the British government was way behind, banks imploded and their stock market fell 75%.

So we certainly have been through this before, so far, at least. While it's certainly respectable in terms of other downturns, it is clearly not unprecedented.

Where's The Bottom?

I have absolutely no idea where the bottom is, and I believe quite strongly that anyone who claims to know is lying, delusional, or both. That said, I also believe it is an irrelevant question. We do know that by every measure, valuations are incredibly cheap. In fact, a recent survey of nearly 10,000 stocks worldwide found that about 10% are selling for less than the amount of net cash on hand and around 30% are selling for a price to earnings multiple of less than 8 (the long term average is 15).

While valuation is not a timing indicator, it is indicative of the extent of the next move, and in this case that move should be substantially up. You simply do not get hurt buying assets at these valuation levels. That's not to say that today's 50% off sale won't be tomorrow's 60% off sale, but ultimately it will all look cheap.

While I may not know exactly where the bottom is, we can try to sort out what has and has not been priced in. I think the credit crisis has been fully priced in, as has a very severe recession. In fact, the fair price of those two events may well be about 10,000 on the Dow with everything between that and our current level reflecting pure emotion.

Oddly enough, in many ways this reminds me a great deal of December of 1999, the height of the dot-com mania in that the environment is being dominated by emotion. The obvious difference is in this case the emotion is panic rather than the euphoria that dominated in 1999. These emotionally dominated markets are akin to a two year old's tantrums; they tend to burn themselves out fairly quickly.

Is There Any Good News?

Great Historical Opportunities Had you bought after the '74-'75 decline you would have had a 500% (5 fold) return over the next twenty years. After the '87 crash you would have had a 900% (9 fold) return in the following twenty years and had you bought following the 2000-2002 decline, you would have had a near 100% in just five years. The aftermath of the Long Term Capital Crisis saw a 26% return in three months. If you had been part of the British crash of the '70's noted above and hung on, you would have nearly doubled your money in a few weeks.

What I think makes this more like the British example of the '70's and less like the other crashes is that these events were not preceded by a mania for stocks. Furthermore this is ultimately a debt and real estate crisis and not an equity crisis.

Valuations Stocks are by any measure incredibly cheap. All of this isn't to say that it will be all fun and games from here on out or that it isn't possible for stocks to get a little cheaper before bouncing back. Over time, however, you simply don't get hurt buying stocks at these levels. Stocks of huge US companies like GE and Pfizer companies are selling at single-digit price to earning multiples and dividends yields higher than anything I've seen in my working lifetime. Internationally there are even greater bargains. Stocks in Western Europe and Japan are selling at, in some cases, less than half of book value. In other words, these companies are selling for significantly less than the value of their buildings, equipment, desk, chairs, etc. As noted above, some of these companies are selling for less than the amount of cash they have in the bank. It's a little like buying a car for \$10,000 that has a \$15,000 bag of money in the back seat. You don't have to know much about cars to realize that you're probably not going to get hurt in the transaction.

Cash on the Sidelines There is an enormous amount of money on the sidelines from individuals, institutions and foreign sovereign wealth funds. All of that money that went out of stock mutual funds (as detailed below) went somewhere and cash is where it went. In addition, corporations went into this downturn with the highest cash balances they've ever had preceding a recession.

Smart Buyers I have spent a great deal of time over the last couple of months meeting, speaking with, listening to conference calls and reading reports from the world's best investors. I have never seen them so enthusiastic about the bargains that are currently out there. Warren Buffet has publicly professed stocks to be cheap only two other times in his career prior to doing so for a third time in a NY Times Op-Ed piece on October 17th.

Some other quotes from very notable investors about the current environment:

"The stock market now reflects a lot of fear, we're buying companies at great prices."

Ron Baron

"I find the current markets a fascinating source of some wonderful bargains"

Robert Arnott

"If stocks are attractive and you don't buy, you don't just look like an idiot, you are an idiot"

Jeremy Grantham

While the last quote might seem a little harsh, it's important to keep in mind that Jeremy Grantham is one of the world's great value investors and almost never thinks anything is cheap. He's a little like Mikey from the old Life cereal commercials who,

it was observed, “won’t eat it, he hates everything.” If Jeremy Grantham eats it, or at least buys it, it must be good.

Sentiment To paraphrase James Grant’s recent piece from the Wall Street Journal, “Investment opportunity follows disillusionment. It’s complacency that precedes bear markets.” We’ve had plenty of disillusionment which has been expressed by people selling their equity mutual funds. In September they redeemed \$46 billion followed by redemptions of another \$71 billion in October, putting us on track to blow the existing quarterly record out of the water. While it may seem perverse, this is actually a good sign, because most retail investors invest on emotion and it generally ends poorly. For example, the last monthly outflow record was July 2002 which was just about the low before the market began its recovery to last year’s highs, as noted above a near 100% return in five years.

Substantially lower oil prices Oil prices are off nearly 70% from their peak earlier in the year. Unlike rising oil prices, this doesn’t seem to get much press. It is a tremendous boost, however, which should go a long way towards mitigating inflation and softening a recession.

Flexible and dynamic financial system As I’ve mentioned in past commentaries, the one thing we’re good at in this country is what economists call creative destruction. In other words we take our lumps, fix our mistakes and get back on the road. Some have made noise that the intervention from the Fed and Treasury have put us on the road to a “lost decade” like that experienced by Japan since their real estate and banking collapse in the early 1990’s. Don’t believe it for a second. We have done more to restructure our banking system in the last 90 days than Japan has done in the last 15 years. In fact, I would argue that one of the causes of the panic has been the blinding speed at which a reworking of our banking system has been undertaken.

Why Didn’t I See This Coming?

A review of commentaries from the past few years certainly shows that a number of the current problems were thought about and discussed in advance. These included the then-developing real estate bubble, problems with sub prime loans, the private equity bubble, hedge fund leverage, derivatives and speculation in emerging markets to name several. These observations were acted on in the summer and fall of 2007 by dramatically reducing the risk profiles that had enabled superior relative performance coming out of the 2000-2002 bear markets. This included reducing, and in some cases eliminating, exposure to stocks overall including Emerging Markets, US and International Small Caps and Real Estate as well as High Yield bonds. Allocations were increased to assets that tend to reduce portfolio risk and were less likely to be affected by the problems noted above. These included significant allocations to cash, US Treasury bonds, US and International Large Cap stocks and Hard Assets. In other words, a conscious effort was undertaken to move from portfolios that did well in an environment where risk was embraced to portfolios that would perform in a more risk-averse environment. This proved effective to a point, and even given the intensely negative environment beginning in September, has provided good relative performance largely insulated from the worst.

So, we dodged a lot of bullets, but got hit with a few others. The real issue has been that markets discounted the effect of a credit crisis and a recession at about 10,500 on the Dow and the areas below that have been reflective of pure emotion, the cause of which is discussed below.

Why Don't We Just Put Everything in Cash Until it Gets Better?

Bear markets tend to end quickly and recover unexpectedly, and trying to forecast precisely when it will occur is all but impossible. The cost of trying to engage in short-term timing can be enormous.

As an example, let's look at the Dow Jones Wilshire 5000 Index, which is pretty inclusive of most US stocks over the decade ending the end of October, which included a big boom and a couple of busts. If you owned that index over that period, you would have gotten a return of 13%. If, however, over those ten years you missed only the ten best days you would have lost 57%. So just by getting the timing wrong and missing ten out of roughly 2,500 days, you would have had a return differential of 70%. So while timing is so intuitively alluring, it is nearly always a practical disaster.

Cash is so tempting in these markets because a guarantee of no return can seem safer than a potential loss. That said, cash is a terrible investment over the long term. \$1 invested in short-term Treasury bills in 1926 would have been worth \$23 at the end of last year, an annual return of 3.9%. That same dollar in Large Cap stocks would have been \$3,384, an annual return of 10.4% and in Small Cap stocks it would have been \$15,249, an annual return of 12.5%.

What About What I See in the Media?

FDR famously said in fireside chats via radio (or television, depending on who you listen to) "We have nothing to fear but fear itself." Were he alive today, he might add "and fear mongering."

While we have had enormous innovations and a deeper understanding of a wide variety of fields, one we have yet to make a dent in changing is human emotion. Fear is one of most basic and strongest emotions. Studies have concluded that fear is, in fact, contagious. When subjects were exposed to faces that expressed fear they began to feel fearful themselves, even when they didn't know what caused the fear. This probably had some useful effect in the days of the caveman. On the other hand they didn't have a flat panel TV, high-speed internet and a Blackberry in the cave to spread the fear nearly as quickly as we can today.

Academic theories aside, the behavior of much of the media has been as appalling as it has been self-serving in the use of fear to drive ratings. In the past when there has been market turmoil, voices of reason came out and tried to calm the masses. Louis Rukeyser performed this role exceptionally well from his Friday night perch on Wall Street Week.

Today, Suze Orman and Jim Cramer have become the commentators that the media turns to. Let's take a look at these two and see how they use their positions of trust.

Jim Cramer hosts a daily show on financial network CNBC, in which he runs around with his sleeves rolled up, screams, throws chairs and other things, and uses silly props while taking calls from listeners and opining on the markets and particular stocks.

On Monday October 6th, Jim Cramer appeared on NBC's Today show and told 6 million viewers "Whatever money you may need for the next five years, please take it out of the stock market right now, this week. I do not believe that you should risk those assets in the stock market right now." That was first thing Monday morning. By the end of the day Friday, the Dow had its worst week in history. Not to say Mr. Cramer caused it, but he certainly didn't help.

Suze Orman has authored a number of books on personal finance and has her own weekly show also on CNBC. In addition she has become the "go to" person for financial matters for CNN's Larry King and Anderson Cooper as well as Oprah and others.

As a rule I don't watch Suze Orman (Mrs. Middleton has forbade it on mental health grounds). I recently broke the rule in the name of research for this commentary and was, frankly, stunned. She came out and said that stocks will be flat or down for the next fifteen years.

Outlandish prognostication and groundless fear-mongering isn't just limited to these two big names. Many lesser-known commentators are trying to elbow into Chicken Little's apparently lucrative world. I recently saw an edition of Nightly Business Review, which claims to be "Television's Most-Watched Evening Business News Program" with 2.6 million viewers. The guest was one Kevin Depew, Executive Editor of Minyanville.com. When asked, "Are you tempted at all to step in and do some buying (of stocks) here?" Mr. Depew replied "Well, not at all. If your timeframe is longer than ten years...then I think that certainly these are the times when you want to be committing as much capital as you can. But if your timeframe is shorter than that, then I think that you have a much more serious problem and you should be focused on capital preservation at this point." In other words he is predicting that stocks will have zero return for the next ten years.

So here we have three pundits telling millions and millions of people to run screaming from stocks. The constitution provides for the right of free speech, but you still can't yell "fire" in a crowded movie theater.

Let's take a closer look at these predictions and then at the predictors. Let's take the predictions stated above and say that stocks, as measured by the S&P 500, will have zero return for the next five to fifteen years. As I write this, the index is at 800. It was last at this level in May of 1997, or over eleven years ago. Putting this together, we are led to believe that stocks will have a 16 to 26 year period with no returns.

The extent to which these assertions are preposterous cannot be overstated. But don't just believe me. Unlike our media darlings, I'll put some defensible research and numbers

behind my assertion. Since 1926 stocks, as measured by the S&P 500, have had only two ten-year periods when you ended up with less than you started with. Not surprisingly, one of these was the 1929-1938 period, when the index was down a total of about 8.5%. Moving forward one year to the 1930-1939 period, the index lost a total of ½ of 1%. That's it. That's as bad as it gets. In no other ten year period have stocks lost money.

Perhaps more interesting is that if you would have bought at the end of those periods, you would have had a return of 151% and 102%, respectively, over the ensuing 10 years. So for the pundit's predictions to hold true, the current situation doesn't have to be as bad as the depression era, it has to be much, much worse. There is simply zero evidence that anything approaching that scenario could possibly be the case.

So much for the facts, let's look at the people behind these predictions. Jim Cramer is well educated, having graduate magna cum laude Harvard (where he was roommates with Steve Ballmer, CEO of Microsoft) and Harvard Law (where he was roommates with Eliot Spitzer). He then started a career on Wall Street working for Goldman Sachs and then legendary hedge fund manager Michael Steinhardt before setting up his own, ultimately very mediocre, hedge fund. The actual performance of that fund is all but impossible to come by and verify. We do know that the fund was relatively small and there was a client letter from the fund that was leaked indicating a 2% return in 1998, a year when the S&P 500 returned 28%.

Mr. Cramer seemed to realize his hedge fund career was limited and went on to co-found the financial website TheStreet.com which did an IPO in the heady days of internet stocks reaching \$60 per share on its opening day only to crash to \$1 in the ensuing dot com bust. He then left the hedge fund industry and focused on his media career, starting his current television show in 2005 where he provides an endless stream of stock picks and pans. Barron's made an attempt last year to sort out the performance history of these picks. When they tried to get the history of the picks from Mr. Cramer and his staff, they were met with "more excuses than a Tour de France cyclist dodging a blood test." They were ultimately able to get the information and the results show a substantial underperformance relative to the Dow and S&P 500, and that's without counting tax and transaction costs.

What is perhaps Mr. Cramer's most famous moment occurred back in the spring when he received a call from a listener who asked about Bear Stearn's stock. Mr. Cramer was quite emphatic and repeated his recommendation to not sell the stock of Bear Stearns. The firm collapsed a few days later. Following this obviously blown call, he tried to back pedal and say what he meant was that if you have an account at Bear Stearns, you should keep the account. The video replays, widely available on the internet, would seem to provide evidence to the contrary. Not very impressive for a person whom CNBC touts as "one of the greatest minds on Wall Street." This was self-promoting hyperbole taken to new and shameful heights.

More famous and widely exposed than Jim Cramer is Suze Orman. I can't really sum up her background any more succinctly than a recent New York Times article which stated "Ms. Orman's own background is financial; she did stints at Merrill Lynch and Prudential

Bache Securities-plus seven years as a waitress at the Buttercup Bakery in Berkeley, Calif.” She did have her own financial planning practice in the early 1990’s which seems to have been mostly a vehicle for selling commission-based insurance products. I have seen nothing to indicate that she has ever actually managed securities portfolios for others, or has any education background in finance or economics (she majored in social work in college).

Bob Veres who is a long-time financial planning industry author and observer said "The big problem with Suze Orman is that she appears to be a below-average financial planner. She scores very high on the personality index, but very low on the knowledge and understanding of the complex issues that face a lot of her audience. She's giving generic, simple solutions to people's most difficult problems, and judging from her portfolio, she's taking them on a path she really hasn't traveled herself."

Looking into the background of Kevin Depew, who predicted that stocks would be flat for the next ten years, is perhaps the most eye opening. As noted before, he is the Executive Editor of Minyanville.com, a website that touts itself as “A Creative Education and Entertainment Community” and “Financial Infotainment” (which apparently involves using lots of cartoons). So what are the qualifications of the person who can peer so clearly ten years into the financial future? His bio on the website under the heading “Meet the Professors” shows a B.A. in Philosophy from the University of Kentucky followed up by five years working at the Daily Racing Form “covering, and occasionally wagering on thoroughbred horses” (I’m not making this up). His major relevant experience was working for a firm that specializes in technical analysis, which is the studying of charts of stock prices and market movements in an attempt to guess the future movements. An endless stream of academic studies have identified technical analysis as the financial equivalent of voodoo. So again, no evidence of any formal background in economics or finance, and no indication that he has ever actually managed a securities portfolio.

As a friend recently said to me “You’re an expert because you raise your hand and say you’re the expert.” At the end of the day these people are coming out with unfounded and outrageous statements to sell books (Suze Orman), increase ratings (Jim Cramer) and drive traffic to a website (Kevin Depew). Good news just doesn’t sell. That’s why these folks are on the prime time shows with the biggest viewer ship and Warren Buffett is relegated to Charlie Rose at midnight. Ratings aside, I’ll take Buffett, Baron, Eveillard, Grantham and Royce and over Cramer, Orman and Depew any day.

The unfounded negative news is no longer the purview of a few pundits anymore. The media malaise has spread to every corner of communications. A very recent headline that appeared virtually everywhere was that unemployment hit its highest level since 1982. Pretty disturbing, right? I’ll acquiesce that the actual number of unemployment claims equals the level from 1982. What generally didn’t get said (and certainly not in the headline) was that the labor force is much larger than it was in 1982. This means that the current unemployment rate is 7%, while in 1982 it was nearly 11%. The average unemployment rate over the fifty years is 6%. Until the last several years, economists didn’t think an unemployment rate below 5% was sustainable.

I've started playing a little parlor game of asking people what percentage of houses they think are in foreclosure. Answers of 30% or more are not uncommon. The real number is around 2%.

One final example of media-fueled misperception, and then I'll put down my freshly ground ax and step off the soapbox. On weekends National Public Radio (hardly the bastion of economic and market forecasting) runs a segment "What Makes it Great" which attempts to deconstruct a piece of music to see why it is or was so successful. On Saturday, November 15th, the piece they selected to analyze was "Brother Can You Spare a Dime" in a piece entitled "A Depression Era Anthem for Our Times."

Conclusion

While these markets are unpleasant, they are not in any way unprecedented and are a normal, if not unfortunate, part of the business and market cycle. Just because it is on TV, in the newspaper or on the internet has no bearing on whether it may actually be true.

The reason stocks produce such superior returns over the long term is because you pay for that return with angst in the short term. Alan Greenspan summed it up nicely in his recent book "The Age of Turbulence" (he was presumably referring to the one he was in rather than the current one, which many attribute to him):

*"Successful investing is difficult. Some of history's most successful investors, such as my friend Warren Buffett, were early to understand the now well-documented anomaly that the rate of returns on stocks, even adjusted for risk, exceeds that on less-risky bonds and other debt instruments, provided one is willing to buy and **hold** equities....The market pays a premium to those willing to endure the angst of watching their net worth fluctuate beyond what Wall Streeters call the "sleeping point."*

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