



Oil Prices Shoot Through The Roof

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“Oil prices hit another high Monday, causing investors to fret about the economy’s health and sell stocks as a result.” We’ve been hearing that a lot lately. However, as timely as that quote seems, it comes from an August 9th business section that I recently ran across – August 9th, 2005. It was reporting that a new record high oil price had been hit - \$63.94.

Those were the days! Sure enough, such a record then did not end up being a large enough roadblock to slow the economy and dampen consumer confidence. Now, however, the virtually unabated rise in oil prices has a host of other villainous cohorts (to the financial markets) that have teamed to produce a level of fear and financial chaos that has not been seen since the Depression.

The second quarter began with a sense of optimism. It was hoped that the shocking Bear Stearns implosion was going to be an isolated incident, and that we were on the back end of having many more mammoth write-downs in the banking and brokerage industries. This optimism was reflected in the performance of world stock markets, which enjoyed healthy recoveries in April and May.

Unfortunately, though, the events of June and July produced one of the more miserable markets in quite some time. With the price of oil leaping upwards on a daily basis, and more and more areas of the economy being crippled as a result, a high of \$147 per barrel of crude became far more than the market could bear. The price has since declined to the *much more acceptable* \$120 range, but the damage had been done.

Incidentally, one of my esteemed colleagues raised the notion that the sudden drop in oil prices off the highs might not be simple market forces at work. He ruminated about the powers-that-be who control oil prices simply letting the price rise until the gas-loving American public reached its “max pain” threshold, as marked by the sell-off in financial markets and consumer confidence levels reaching historic lows. Despite the conspiratorial nature of such a thought, these days, it doesn’t seem quite that far-fetched, does it?

Well, on top of record oil prices, any hopes for a near-term recovery in the housing and mortgage sectors were wiped away as it became clear that mortgage giants Fannie Mae and Freddie Mac were in severe trouble. These two firms alone hold or back roughly half of all mortgages in the U.S., making the problems of Bear Stearns look like a walk in the park compared with the threat of their demise. Once again, Treasury Secretary Henry Paulson and other officials in Washington were left with no choice but to step in and

assure investors around the world that any and all efforts would be taken to ensure that Fannie and Freddie survived.

Coat-tailing that startling news was word that IndyMac Bank had succumbed to the awful banking conditions, and that it would have to be seized by federal regulators. As the FDIC got to work, estimates had this pegged as the second-largest bank failure in U.S. history. Rumors then began flying that banks of all sizes would begin closing their doors.

Not coincidentally, from the moment that IndyMac's failure became apparent, we have been inundated with questions about the safety of the money that we manage, and understandably so. Thus, we thought it would be helpful to provide a thorough answer to those questions for those of you who might be wondering about it, but have not yet raised the issue directly with us.

Unlike the banking industry, in which accounts are federally protected via \$100,000 of FDIC insurance (\$250,000 for IRA's), brokerage accounts, such as yours at Schwab Institutional, are covered under SIPC insurance. The SIPC covers up to \$500,000 in account value, of which up to \$100,000 of cash is covered. However, for Institutional clients, Schwab has contracted with Lloyd's of London to provide additional insurance for, essentially, the entire balance of your account, to the extent that the SIPC limits are exhausted. The Lloyd's insurance caps out at \$150 million per customer, including cash of up to \$1 million.

Remember that this coverage, like the SIPC's, is not for market losses in your portfolio. It covers impropriety or failure on the part of Schwab itself. Fortunately, there is absolutely no indication that Schwab is in trouble. On the contrary, they have been run very conservatively over the years. Nevertheless, it's good to know that the Lloyd's coverage is there just in case the unthinkable happens.

The trouble with the situation we find ourselves in, though, is that the unthinkable is really no longer unthinkable. And until that fear that another large shoe could drop at any moment has subsided, we're unlikely to see any kind of meaningful, sustained positive momentum. The U.S. Congress is attempting to be proactive, as evidenced by its passing yesterday of a bill intended to help homeowners facing foreclosure, spur new home buying, and shield Fannie and Freddie from catastrophe. It's too early to tell what impact such legislation will have, and how much worse things might get before the intended benefits kick in.

Of course, the toughest part of all of this is to decide what, if anything, you should do with your portfolio during these turbulent times. As you know, we do not employ market-timing techniques. In our view, such endeavors pose far too much risk to a portfolio over time. That doesn't mean that we turn a blind eye to current market conditions. Quite the contrary. It does mean, however, that we do what we can to take the emotion out of the investment process, and attempt to adhere to well-thought-out plans that have been proven to succeed time and again.

We don't know when this financial mess will be resolved, or when the crisis of confidence will end. What we can say with a relative degree of confidence, however, is that these tough times will pass – and when they do, the stock markets again will become a wonderful tool for wealth building.

Buy? Sell? Hold? In general, we would say that if the emotion of these times is getting the best of you, there's certainly nothing wrong with pulling back on your equity allocation if it will allow you to sleep better. On the other hand, the contrarian viewpoint would be to buy "when there's blood in the streets". The hardest thing to do is to buy something that everyone else is selling, and we're certainly not espousing the view that you should be diving head first into the market right now. However, if you have a long enough time horizon, dabbling here and there into, say, the beaten down financial sector, will likely have been a prudent move when viewed from the rear view mirror a few years from now.

We welcome any discussion you would like to have about your portfolio. Hope you have an enjoyable remainder of the summer.

Warm regards,

Tony Reed, CPA, CFP
President