AMERICAN MONEY MANAGEMENT, LLC

SEC Registered Investment Advisor

PO Box 675203, Rancho Santa Fe, CA 92067 | Tel: 888-999-1395 | Fax 866-364-1084 | info@amminvest.com | www.amminvest.com

First Half Review

The first half of 2008 dramatically reinforced the idea that over the short term, the stock market can be extremely volatile. A sharply negative first quarter was followed by two months of positive returns, but the stock market sell off resumed in June. The S&P 500 is down 11.9% for the first half of this year with international markets down 12.7% (MSCI EAFE). There were some bright spots, specifically investment-grade bonds that experienced positive returns for the year; however, according to Morningstar, the average intermediate bond mutual fund was down 0.6%. The financial sector took a big hit in the first half; Citicorp was down 43%, Wells Fargo was off 21%, and some major banks are in serious trouble.

The Importance of Strategic Allocation

As expected in an environment of fear, there are a lot of questions: What is going on? How bad could it get? What should be done in investment portfolios? Though this particular environment is in many ways unique and presents its own set of challenges, we want to reiterate our success in navigating through a number of financial crises in the past. While each of those periods presented their own particular challenges, one thing that was common to them all was a sense of accelerating bad news, escalating risk, fear, and panic.

This is why helping clients select an appropriate investment objective is so important. It is times like these that illustrate the importance of getting the right investment objective for clients, i.e., mixture of stocks and bonds. Young clients can ride out this volatile market by keeping their eyes fixed on the long-term, knowing that stocks will outperform bonds over time. Retired clients need to have a good portion of their portfolios in bonds and other income oriented investments, helping to cushion the portfolio when stocks fall a significant amount.

Mark Twain's Frog

Traditionally, American Money Management has focused on protecting client assets by increasing reserves when the stock market is overvalued or seems to be especially vulnerable, as was the case last year. This year, however, many sectors are already very depressed, and valuations are much more appealing. As market legend Barton Biggs advised, you do not want to be like Mark Twain's frog who would never sit on a stove again after being burned and, as a result, froze to death. Although, most clients are underweighted in stocks compared to their objective weights, we do not feel that now is the time to be entirely in cash.

What We've Learned From Past Market Cycles

As always, there are positives in this environment as well. Outside the financial sector, corporate balance sheets remain generally healthy and earnings have been decent. One source of strength has been exports, which have managed to offset much of the impact of the housing decline on U.S. economic growth so far. But overall, risks to the economy remain high, and the financial and stock markets are now more fully discounting this risk—evidenced by the battering stocks have taken in recent weeks.

OVER

Though we have seen a number of market crises over the years, we also recognize that history never repeats itself exactly, and almost anything can happen from here. One possibility is that things in the stock market could get worse before they get better. Even without a bad recession, fear and pessimism can take hold of investor psychology and send the market down further than what would be justified by long-term economic fundamentals. In this type of environment, a sense of perspective and a reliance on our investment discipline help us avoid becoming panicked by short-term concerns and paralyzed by longer-term uncertainty.

Fear Creates Opportunity

Our experience in past market cycles and our analysis of the current market environment lead us to two important conclusions. First, we believe it is important to have a proper perspective. It is easy to put too much weight on negative scenarios when bad news dominates the daily headlines. And, we currently view stocks as priced to outperform bonds and cash in most scenarios over the next five years. Second, big market downturns invariably present opportunities. Without them, we would not have had the chance to invest in excellent funds and businesses at bargain prices.

> **"If a stock I own goes down 50%, I'd look forward to it. In fact, I would offer you a significant sum of money if you could give me the opportunity for all of my stocks to go down 50% over the next month." -** *Warren Buffett, at the Berkshire Hathaway annual meeting, May 2008*
> Mr. Buffett has experienced his biggest peak to trough decline in 18 years. Even so, he wants prices to go lower knowing that he can buy more great businesses before they bounce back. The "world's most successful investor" always aims to profit from market declines and volatility.

Our investment discipline and focus on what is knowable help us to identify those asset classes where investor panic has led to excessive undervaluation. Currently, we are closely monitoring three asset classes where valuations have become more attractive: Blue chip stocks, information technology and income securities (preferred stock, high yield bonds, etc).

If you are an investor, "a bear market is a gift from the financial gods – and the longer it lasts, the better off you will be. Instead of running from the bear, you should embrace him." *- Jason Zweig, Wall Street Journal 7-12-08*

Conclusion

We suspect this will continue to be one of the most challenging investment environments we have faced, at least for a while. We also know that many of the managers we respect are buying shares of high-quality companies at bargain-basement prices. Even though the overall market remains weak, the current economic and market turmoil appears to be creating significant opportunities for bargain hunters with a reasonable time frame.

Indeed, it is often when the overall trend is negative that disciplined investors can build a portfolio for long-term out-performance by carefully taking advantage of the opportunities created by these dislocations. This requires patience as well as the ability to favor long-term analysis over short-term fear, which is what distinguishes successful investors.

We appreciate your continued trust and confidence. Please feel free to contact us if you have any questions.

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Your Portfolio Management Team

Gabriel Wisdom, *Managing Director*
Michael Moore, *Chief Investment Officer*
Joseph Dang, Esq., *In-House Counsel*
Jim Rhodes, CFA, *Executive Director*
Tom Jolls, *Executive Director*
Adele Canetti, *Portfolio Manager*
Glenn Busch, *Portfolio Manager*
Vicki Moore, *Operations Manager*
Erik Carter, CFP, *Financial Planner*